INSIDE THIS WEEK: A 14-PAGE SPECIAL REPORT ON THE EURO AREA

The Economist

JUNE 13TH–19TH 2009 Economist.com

Debt

The biggest bill in history

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Debt
The right and wrong ways to deal with the rich world's fiscal mess: leader



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Politics this week

Jun 11th 2009
From The Economist print edition

AP

The **European elections** saw a record low turnout of 43%. The centre-left did badly in most countries. The centre-right European People's Party (EPP) will remain the biggest group in the European Parliament. Far-right and Eurosceptic parties did well in Britain, the Netherlands, Hungary and several other countries. See article

After the centre-right's victory the **European Commission** president, José Manuel Barroso, who is backed by the EPP, formally put himself forward for another five-year term. He is expected to be confirmed in the job by national governments next month.

Despite (or because of) the Labour Party's dismal performance in the European and local elections, **Gordon Brown** faced down critics who want him to quit as Britain's prime minister. Mr Brown may now survive until the next general election, due before June 2010. Several ministers resigned ahead of a planned government reshuffle. See article

Libya's leader, Muammar Qaddafi, visited **Italy** for the first time since he took power in 1969. As the former colonial power, Italy last year paid reparations to Libya for its past misdeeds.

Now in your backyard

The first non-American detainee at **Guantánamo Bay** was brought to the mainland to face trial. Ahmed Ghailani pleaded not guilty in a federal court in Manhattan to charges in connection with the bombings of American embassies in Kenya and Tanzania in 1998.

Creigh Deeds won **Virginia's** Democratic primary for governor, easily beating Terry McAuliffe, the chairman of Hillary Clinton's presidential campaign.

An 88-year-old man with an anti-Semitic past opened fire at the **Holocaust Memorial Museum** in Washington, DC, killing a security guard.

Democrats infuriated Republicans by setting July 13th as the date for hearings on **Sonia Sotomayor**, Barack Obama's Supreme Court nominee. The Republicans wanted to wait until the autumn.

Staking a claim

Reuters



Two dozen police and at least nine Indians were killed in violent clashes in **Peru's** northern jungle. For the past two months, Indians have blocked roads and oil pipelines in protest at decrees aimed at facilitating oil exploration and development in the jungle, which they say threaten their control over their traditional lands. Congress later suspended two of the decrees. The protest leader sought asylum in Nicaragua.

Brazil's Senate approved a law granting legal title to informal private landholdings in the **Amazon** region. President Luiz Inácio Lula da Silva said he would veto clauses applying the measure to companies and absentee landlords.

Canada's left-wing New Democrats easily won a provincial election in Nova Scotia, their first victory in the Atlantic provinces.

At least 44 children died in a fire at a day-care centre in the city of Hermosillo, in northern **Mexico**. The blaze started in a warehouse next to the nursery, which had only one working exit and no windows.

Two soldiers and 18 **drug gangsters** were killed in a shoot-out in the Mexican resort of Acapulco.

Taliban terror

A suicide-bomb attack on the main international hotel in Peshawar, capital of **Pakistan's** North-West Frontier Province (NWFP), killed at least 18 people, including two foreign United Nations workers. Pakistani officials blamed the Taliban, and speculated that the bombing was in reprisal for the army's continuing offensive against Taliban fighters in NWFP's Swat Valley.

Pakistan's prime minister, Yusuf Gilani, called an emergency meeting in **Karachi**, the most populous city, after at least 30 people were killed in political violence sparked by rivalry between the city's dominant party, the Muttahida Qaumi Movement, and a breakaway faction.

The **Sri Lankan** government turned away a ship from Britain bringing aid for Tamil civilians displaced by fighting in the north, apparently suspecting the Tamil exiles who sent it of sympathies with the defeated rebels, the Liberation Tigers of Tamil Eelam. See article

The UN Security Council prepared to vote on a resolution that imposes tougher sanctions on **North Korea** after its recent testing of a nuclear device and several missiles. Earlier, a court in Pyongyang sentenced two American journalists to 12 years' hard labour for entering the country illegally.

The tiny Pacific country of **Palau** accepted 17 former prisoners from the Guantánamo Bay detention centre. The 17 are Uighurs, Muslims from the Chinese region of Xinjiang. China had demanded their repatriation and other countries were reluctant to accept them for fear of China's anger.

Not forgotten

AP



Royal Dutch Shell agreed to pay $15.5m in compensation to the Ogoni people of the **Niger Delta** to end a long-running court case brought against the oil giant by nine plaintiffs, including relatives of Ken Saro-Wiwa, a slain environmental campaigner. They accused Shell of complicity in Mr Saro-Wiwa's execution by the Nigerian government in 1995. Shell denies any wrongdoing; it described the money as a "humanitarian gesture". See article

The March 14th alliance, a Western-backed coalition, retained its parliamentary majority in a tightly contested election in **Lebanon**. The opposition, including the Islamist militia Hizbullah, won a greater share of the popular vote but accepted its defeat. See article

Inspectors from the International Atomic Energy Agency reported that they had found more unexplained traces of uranium in Syria, which still denies having a secret **nuclear programme**. Iran's uranium production has expanded, making it harder for inspectors to audit.

Iranians prepared to go to the polls in a presidential election on June 12th. President Mahmoud Ahmadinejad faces a strong challenge from his main rival, the reformist Mir Hosein Mousavi.

After some confusion, it was confirmed that Africa's longest-serving leader, President Omar Bongo of **Gabon**, had died. He became president in 1967 and subsequently won several polls. His opponents argued that this had more to do with election-rigging than personal popularity.

Business this week

Jun 11th 2009
From The Economist print edition

A significant point was reached in the American Treasury's bank-rescue plan when it let ten financial companies repay a combined total of $68 billion in loans they had received under the **Troubled Asset Relief Programme**. The ten include JPMorgan Chase, Goldman Sachs, Morgan Stanley and American Express. Timothy Geithner, the treasury secretary, said the repayments were encouraging, but warned that the crisis in the banking industry was not over yet. See article

Citigroup (which was not among the ten) launched a capital-raising scheme in which it will convert $58 billion in preferred stock to common equity. The share exchange was put forward in February as part of Citi's third bail-out. It is rumoured that the offer was delayed because of growing unease at the Federal Deposit Insurance Corporation, a regulator, with Citi's management.

Lloyds Banking Group repaid £2.3 billion ($3.8 billion) of the money it received from the British Treasury after raising funds through an open offer of shares. Lloyds meanwhile continued its restructuring process, and said its Cheltenham & Gloucester-branded bank branches would close.

Pay and display

The Obama administration laid out proposals on **executive pay**, but said it would not seek caps on salaries. It also appointed a "special master" to monitor pay at companies that have received the most government aid. Kenneth Feinberg is a prominent lawyer who has mediated in notable cases, including assessing compensation for the lives of those killed in the September 11th 2001 attacks. See article

The **European Central Bank** lent €3 billion ($4.2 billion) to Sweden's central bank as part of an effort to avoid a meltdown in the Baltic region triggered by Latvia's potential currency devaluation. Swedish banks dominate the Baltic financial sector. See article

America's Supreme Court cleared the way for **Chrysler** to leave bankruptcy protection when it declined to hear an appeal from a group of pension funds claiming the government was overlooking their rights as Chrysler's senior creditors. Soon after the Court's decision **Fiat** sealed its alliance with Chrysler, in which it is buying most of the Detroit carmaker's assets.

General Motors said Edward Whitacre will be its new chairman when it leaves bankruptcy protection sometime over the summer. Mr Whitacre used to run AT&T, and is credited with turning a dinosaur into a fleet-footed telecoms company. Although he has never been in charge of a manufacturing company, the 67-year-old Mr Whitacre promised to "learn about cars".

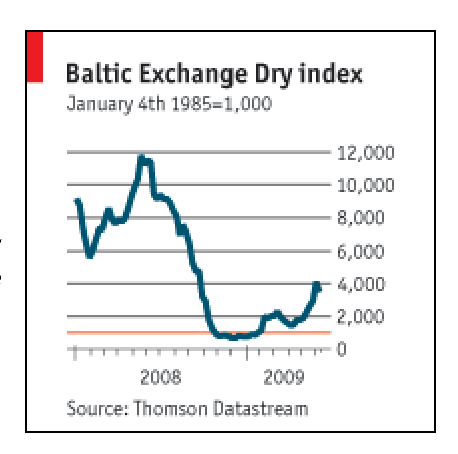
Arcandor, a German retailing and tourism group, filed for insolvency after Germany's government refused its request for a bail-out. With thousands of jobs at risk, Metro, a competitor, revived its offer to take over Arcandor's Karstadt department-store chain. See article

China's national steel association joined industry groups in Europe and Japan objecting to the merger of **BHP Billiton's** and **Rio Tinto's** operations in Western Australia, which would create the world's biggest producer of iron ore. The Chinese said the agreement had a "strong monopolistic colour". The deal was announced on June 5th, the same day Rio made a dramatic reversal and abandoned its controversial deal with Chinalco, in which it would have got a $19.5 billion investment from China's state aluminium company. Rio will instead raise capital through a share issue.

Dry run

The Baltic Exchange Dry index, which measures the **shipping costs** for commodities, reached its highest level since September, mostly because of

rising demand in China for iron ore, coal and grains.



The **price of oil** closed above $70 a barrel on June 10th for the first time this year.

Standard & Poor's warned Asian countries that their **sovereign-debt ratings** were at risk of being downgraded. The credit-rating agency recently lowered its outlook from "stable" to "negative" for India and Taiwan because of their "fiscal deterioration" caused by massive economic support programmes. Meanwhile, S&P lowered its debt rating for Ireland, again.

Globe theatre

The biggest union at the *Boston Globe* narrowly rejected a package of changes to pay and benefits which its owner, the New York Times Company, said were vital if the *Globe* was to avoid closure. The company prepared to introduce a unilateral 23% cut in salaries at New England's biggest newspaper, and began looking for a buyer.

The latest estimate of losses for the **airline industry** this year doubled to $9 billion. To cut costs KLM, a Dutch carrier, has asked its pilots to volunteer for ground work, such as handling bags and hospitality.

KAL's cartoon

Jun 11th 2009
From The Economist print edition

Illustration by KAL



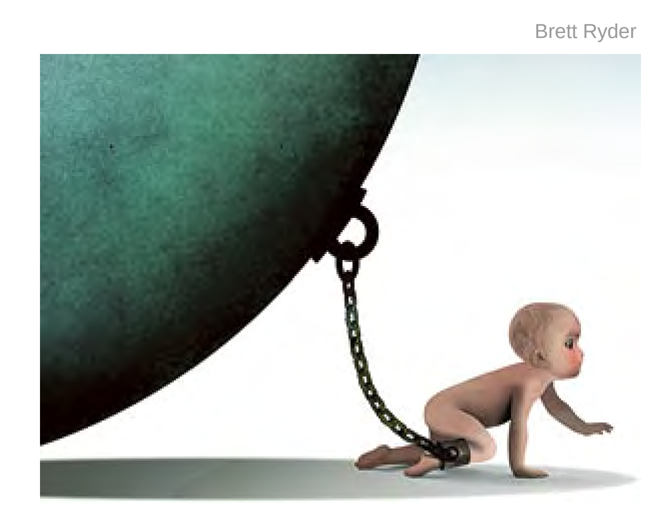
Public debt

The biggest bill in history

Jun 11th 2009
From The Economist print edition

The right and wrong ways to deal with the rich world's fiscal mess

Brett Ryder



THE worst global economic storm since the 1930s may be beginning to clear, but another cloud already looms on the financial horizon: massive public debt. Across the rich world governments are borrowing vast amounts as the recession reduces tax revenue and spending mounts—on bail-outs, unemployment benefits and stimulus plans. New figures from economists at the IMF suggest that the public debt of the ten leading rich countries will rise from 78% of GDP in 2007 to 114% by 2014. These governments will then owe around $50,000 for every one of their citizens (see article).

Not since the second world war have so many governments borrowed so much so quickly or, collectively, been so heavily in hock. And today's debt surge, unlike the wartime one, will not be temporary. Even after the recession ends few rich countries will be running budgets tight enough to stop their debt from rising further. Worse, today's borrowing binge is taking place just before a slow-motion budget-bust caused by the pension and health-care costs of a greying population. By 2050 a third of the rich world's population will be over 60. The demographic bill is likely to be ten times bigger than the fiscal cost of the financial crisis.

Will they default, inflate or manage their way out?

This alarming trajectory puts policymakers in an increasingly tricky bind. In the short term government borrowing is an essential antidote to the slump. Without bank bail-outs the financial crash would have been even more of a catastrophe. Without stimulus the global recession would be deeper and longer—and it is a prolonged downturn that does the greatest damage to public finances. But in the long run today's fiscal laxity is unsustainable. Governments' thirst for funds will eventually crowd out private investment and reduce economic growth. More alarming, the scale of the coming indebtedness might ultimately induce governments to default or to cut the real cost of their debt through high inflation.

Investors have been fretting on both counts. Worries about default have been focused on weaker countries in the euro area, particularly Greece, Ireland, Italy, Portugal and Spain, where the single currency removes the option of unilateral inflation (see our special report). Ireland's debt was downgraded for a second time on June 8th. Fears of inflation have concentrated on America, where yields on ten-year Treasuries reached nearly 4% on June 10th; in December the figure was not much above 2%. Much of this rise stems from confidence about economic recovery rather than fiscal alarm. Yet eye-popping deficits and the uncharted

nature of today's monetary policy, with the Federal Reserve (like the Bank of England) printing money to buy government bonds, are prompting concerns that America's debt might eventually be inflated away.

Justified or not, such worries will themselves wreak damage. The economic recovery could be stillborn if interest rates rise too far too fast. And today's policy remedies could become increasingly ineffective. Printing more money to buy government debt, for instance, might send long-term bond yields higher rather than lower.

What should policymakers do? A sudden fit of fiscal austerity would be a mistake. Even when economies stop shrinking, they will stay weak. Japan's experience in 1997, when a rise in consumption taxes pushed the economy back into recession, is a reminder that a rush to fiscal tightening is counterproductive, especially after a banking bust. Instead of slashing their deficits now, the rich world's governments need to promise, credibly, that they will do so once their economies are stronger.

Lord, make me prudent—but not yet

But how? Politicians' promises are not worth much by themselves. Any commitment to prudence must include clear principles on how deficits will be shrunk; new rules to stiffen politicians' spines; and quick action on politically difficult measures that would yield future savings without denting demand much today, such as raising the retirement age.

Broadly, governments should pledge to clean up their public finances by cutting future spending rather than raising taxes. Most European countries have scant room for higher taxes. In several, the government already hoovers up well over 40% of GDP. Tax reform will be necessary—particularly in places, such as Britain and Ireland, which relied far too much on revenues from frothy financial markets and housing bubbles. Even in the United States, where tax revenues add up to less than 30% of GDP, simply raising tax rates is not the best answer. There too, spending control should take priority, though there is certainly room for efficiency-enhancing tax reforms, such as eliminating the preferential tax treatment of housing and the deductibility of employer-provided health insurance.

The next step is to boost the credibility of these principles with rules and institutions to reinforce future politicians' resolve. Britain's Conservative Party cleverly wants to create an independent "Office for Budgetary Responsibility" to give an impartial assessment of the government's plans. Germany is poised to pass a constitutional amendment limiting its structural budget deficit to 0.35% of GDP from 2016. Barack Obama's team wants to resurrect deficit-control rules (see article). Such corsets need to be carefully designed—and Germany's may prove too rigid. But experience from Chile to Switzerland suggests that the right budgetary girdles can restrain profligacy.

Yet nothing sends a stronger signal than taking difficult decisions today. One priority is to raise the retirement age, which would boost tax revenues (as people work longer) and cut future pension costs. Many rich countries are already doing this, but they need to go further and faster. Another huge target is health care. America has the most wasteful system on the planet. Its fiscal future would be transformed if Congress passed reforms that emphasised control of costs as much as the expansion of coverage that Barack Obama rightly wants.

All this is a tall order. Politicians have failed to control the costs of ageing populations for years. Paradoxically, the financial bust, by adding so much debt, may boost the chances of a breakthrough. If not, another financial catastrophe looms.

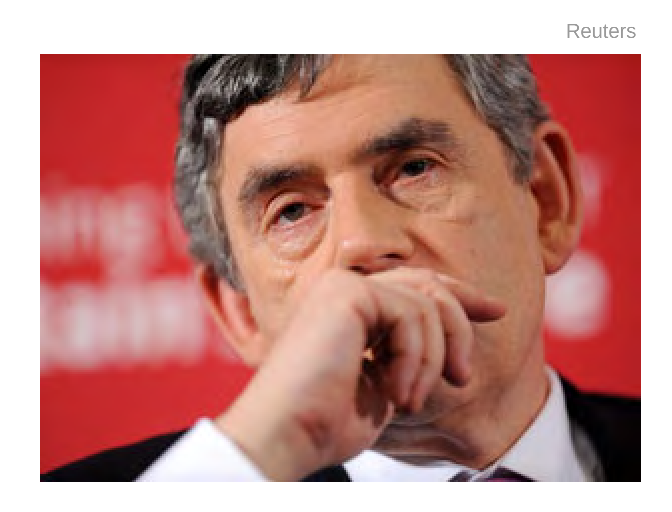
Gordon Brown stumbles on

Reprieved

Jun 11th 2009
From The Economist print edition

The prime minister's survival is probably bad news for his party, but not necessarily for his country

Reuters



GORDON BROWN may lack the political graces but one quality he has in abundance: sheer bloody-minded grit. After a week in which ten ministers resigned, backbenchers threatened to sack him and his humiliated Labour Party got its smallest share of a national vote in almost a century (see article), the prime minister is still here. On sufferance, it is true; beholden to various big beasts in his cabinet (see article); and vulnerable to bad news from by-elections and the like in the 12 months before a general election must be held. But, against an admittedly gutless bunch of would-be regicides, he has clung on by his bitten fingernails. Is this good news or bad?

For his party, it is probably bad. In the fag-end of its 12-year reign, Labour has lost even core supporters. It is punished for greedy MPs' pumped-up expenses. It is blamed, if not for the economic collapse, at least for not protecting ordinary folk from its rigours. There is a bone-weariness with the whole New Labour narrative, which promised so much and delivered much less. Mr Brown himself has failed signally to breathe new energy into an exhausted government.

Labour had much to gain from dispensing with Mr Brown's services. Polls this week confirmed that the party would get more votes at a general election under a different leader. But it would still lose, which is why Mr Brown is with us today. Replacing one unelected prime minister with another might have seemed a democratic deficit too far, forcing an early election. Rather than anticipate a popular judgment that promised to be harsh, Labour MPs decided to keep their leader.

Mr Brown has a chance now to do two big good things during his remaining time in office. The first is fixing Parliament. This means more than ending self-regulation; the scandal over MPs' expenses has put paid to that in any event. It involves strengthening the institution, cutting the power of parties over members, expanding the role of committees and more; Mr Brown's nod in that direction this week was welcome. It does not mean wholesale constitutional reform in less than a year.

Nobody would want to stifle debate on changing the electoral system (on which Labour long ago promised a referendum). But the "Democratic Renewal Council" that Mr Brown has heart-sinkingly set up is a blatant attempt to play a get-out-of-jail-free card. A government with little time, no money and bad poll ratings will not capture the moral high ground by threatening to change rules that promise its rivals victory. Better, as this newspaper argued last week (see article), for Mr Brown to speed up the independent review of MPs' expenses that is already in the works, thus mercifully moving politics on from moats and duckhouses, and then call an election later this year.

Less spin, more stats

On the basis of Mr Brown's behaviour so far, such public spiritedness seems unlikely. That reinforces the importance of his second job: showing how the public finances can be fixed. Britain's problems are not unique (see article), but the huge projected deficits for years to come are worrying investors. Waffling about efficiency gains is not enough. Mr Brown needs to be clearer about what spending must be cut and what taxes raised. His last attempt to do this—in the budget—was a mockery of spin. If he wants to soldier on to the (probably bitter) end, better to go down honestly. And it would do his party, too, more good than any of the cheap gimmicks (embarrassing videos, calls to talent-contest judges, giving jobs to TV stars) in which he has recently indulged. His dour pragmatic side is well-suited to delivering bad news and explaining how to deal with it. If Mr Brown starts telling the unvarnished truth, the Tories will have to work a lot harder to win the election.



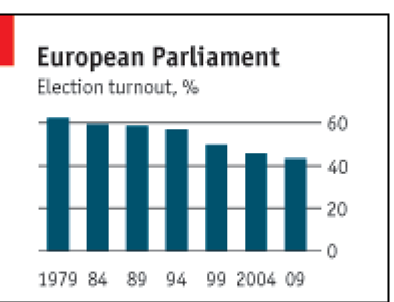
The worrying European elections

Trouble at the polls

Jun 11th 2009
From The Economist print edition

Many of Europe's voters do not like the European Union. Most of the rest don't care. They should

IT WAS formally one election to a single body, the European Parliament. Yet in truth what took place between June 4th and June 7th were 27 separate polls, as both campaigners and voters focused mainly on national issues, not European ones. The dream of a European demos nourishing a pan-European democracy based on Europe-wide parties is more distant than ever. Even so, voters from Nuorgam in northern Finland to Tarifa in southern Spain seemed to share some ideas—and they are not reassuring for the European Union.



The first was indifference. The average EU-wide turnout was 43%, the lowest since the first direct elections to the European Parliament in 1979. The pattern is not universal: turnout actually rose in seven countries, and it was lower in eastern than in western Europe. But almost everywhere turnout was far below levels in national elections. Thirty years on, that should worry not only new MEPs in Strasbourg, but also the leaders in Brussels and national capitals who steer the EU.

A second common element was a harsh judgment on the mainstream left. Most governments of the left suffered heavy defeats (as in Britain, Hungary, Portugal and Spain). But the left did badly even where it is in opposition (France and Italy) or in coalition with the mainstream right (Germany, the Netherlands and Austria). The umbrella Socialist group in the European Parliament lost as many as a quarter of its seats, leaving the mainstream centre-right group, the European People's Party, more dominant than before, despite the imminent departure of British Conservatives who plan to form a new anti-federalist centre-right group (see article).

At first blush the woes of the mainstream left are surprising. Most of the EU is in deep recession, unemployment is rising and talk is of a crisis of capitalism—fertile ground for centre-left parties that favour higher taxes and more regulated markets. Yet the left's appeal is waning. One reason is a string of unimpressive leaders who have offered little to take the place of globalisation. But it also reflects the ability of some on the centre-right, especially Germany's Angela Merkel and France's Nicolas Sarkozy, to steal the left's clothes, with policies such as a bigger state and tougher regulation, and to persuade voters that the economic crisis came from abroad. Voters in Britain, Spain and Ireland, who saw their governments as responsible for their economic problems, punished them.

The worrying antis

The third feature of the elections was a sour and negative mood, shown not merely in a low turnout but also in wide support for a ragbag of far-right, populist, anti-EU or plain nutty parties. These ranged from the eccentric United Kingdom Independence Party and Geert Wilders's Freedom Party in the Netherlands, which both came second in their national polls, to Hungary's anti-gypsy Jobbik party and the Pirate Party in Sweden. Some of this was protest voting. But a chunk reflects views deeply antithetical to all that the EU stands for.

Why should it matter if mavericks give the EU a good kicking from time to time? True, the parliament has powers over EU legislation that will be further increased if the Lisbon treaty is ratified, but for the most part its loonier fringes can be safely ignored by their saner colleagues. Brussels has got around such trifles as negative opinion polls and even lost referendums: witness the unwanted EU constitution, now cross-dressed as the somewhat-less-awful Lisbon treaty. Indeed, from a liberal point of view, the freshly kicked Eurocrats might be less inclined to impose yet more unwanted bureaucracy on a continent already mired in red tape.

But once you look at some of the things that the kickers want to introduce, the picture is less reassuring. Protectionism and nationalism threaten the foundations of free-market economics. The single market is already under attack from several governments, as is the notion of admitting Turkey to the club. Attacks on immigration and minorities slide too easily into xenophobia, racism and homophobia. Extremist parties across Europe must be resisted because they are a danger not just to the EU but to basic civil liberties.

And is it so helpful to smash the institutions of the EU? Bodies such as the European Commission and the European Central Bank do not have the longevity or legitimacy that attach to their national counterparts. Yet some parts of the commission have been the doughtiest fighters for both free trade and enlargement. The ECB is one of Europe's successes: as our special report in this issue argues, the euro has proved a haven in the economic crisis—so much so that no country seriously wants to leave it and plenty want to join. But the ECB was recently attacked by Mrs Merkel, supposedly the guardian of its independence. If European institutions operate without firm political support, it is fanciful to hope that they will remain strong enough to take sometimes unpopular decisions. And many of the causes that may suffer will be liberal ones.

It is not hard to see why so many Europeans chose to boycott these elections. But they may come to regret that choice.

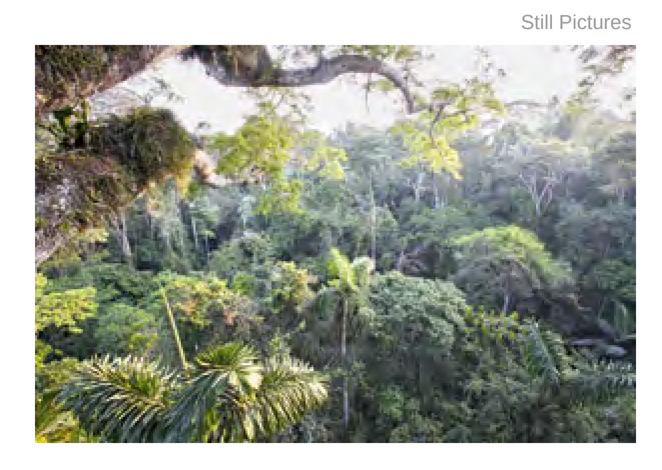
Deforestation and carbon credits

Seeing REDD in the Amazon

Jun 11th 2009
From The Economist print edition

Saving rainforests needs both property rights and payments

Still Pictures



FORESTS lock up a lot of carbon. Cutting them down accounts for around 20% of the world's emissions of greenhouse gases. On paper, halting deforestation should be the simplest way to cut emissions. Achieving a similar reduction by building wind turbines or nuclear-power stations, or by mandating more fuel-efficient cars and buildings, would take years and cost billions. In practice, however, halting deforestation is hard: much of the world's rainforest has already succumbed to loggers and farmers. That is because it is difficult to align the interests of people who live in forests (now 20m in the Brazilian Amazon) with those of the rest of humanity.

The best way of doing so involves a mixture of two ideas: establishing clear property rights over land and paying its owners not to cut down trees. If these policies are to work anywhere, it will be in Brazil, which possesses 60% of the world's greatest tropical forest. Brazil has powerful motives for preserving the Amazon. Deforestation does terrible damage to the reputation of a country that is a pioneer in renewable energy. It also puts at risk the Amazon rain factory that enables Brazil to be one of the world's biggest agricultural exporters.

Brazil now has a sophisticated system for monitoring deforestation from satellites and aeroplanes. It has set aside some 40% of the Amazon as national parks or Indian reserves. It has laws that restrict deforestation in the rest. The problem is enforcing those laws over a vast area where many of the inhabitants dislike the rules (see article). The first step is a proper land registry to confirm who owns what. Some 15-25% of the Amazon is private property, which is supposed to be kept 80% forested (though often is not). Most of the rest is nominally federal land, but in practice is up for grabs: title deeds are forged, people are killed and deforestation accelerates because of competing claims. Some farmers even clear trees as a way to solidify land claims: fines from Brazil's environmental agency can create a paper trail that acts as proof of ownership.

A law approved this month by Brazil's Congress aspires to end this mess—but at a price. It would grant title to all landholdings up to 1,500 hectares (3,700 acres) occupied before 2005 in the Amazon, comprising an area the size of France, and ban further land claims. The law entrenches injustice: it risks rewarding people who used violence to obtain land, including large landholders who occupy almost 90% of the area under discussion. Brazilian greens want to limit the measure to smaller plots, and to ban their resale for ten years.

Yet that risks defeating the object. Better for the government to complement this attempt to end battles over privately owned land with a decision to take the rest of the Amazon into public ownership, as parks or reserves. Countries with rainforests also need to have due regard for their preservation and for the Indians

who live in them when allowing mining and oil exploration. The lack of such procedures was behind a bloody clash in Peru this month (see article).

Lay down that axe and you will get cash

At the moment it makes economic sense to cut down trees: those who do so can sell the timber and turn the land into farms or ranches. So the second idea for saving forests lies in changing economic incentives by paying people not to chop down trees—an idea known in the ghastly jargon of climate-change diplomacy as “reduction of emissions from deforestation and degradation” (REDD). Since many rich countries felled their forests as they developed it seems fair that they should pay some of the cost of this.

There are difficulties, though. One is that “avoided deforestation” is hard to define and quantify. Another, raised by officials in Europe who have chosen not to include REDD in the European carbon-trading scheme, is that the carbon market would be flooded with deforestation credits that will push down the price. Companies would then buy cheap credits and continue doing business as usual rather than cutting their own emissions. Further tricky issues abound: who should have the right to sell credits? How should the money be split between central governments, local governments and indigenous people? And should the money be paid in perpetuity?

REDD schemes will require careful monitoring to ensure that forests really are left intact and that carbon credits for an area are not claimed more than once. Murky goings-on in Papua New Guinea, one of the leading advocates of REDD, highlight such worries (see article).

Even so, it is worth trying, simply because avoiding deforestation is so effective in slowing carbon emissions. So REDD deserves a place in the world climate treaty to be negotiated in Copenhagen in December, to replace the Kyoto treaty when it expires in 2012. As with other forms of carbon credit, today’s voluntary and experimental REDD schemes will need to be replaced by more rigorously accredited and monitored schemes. But they have a chance of working only if the countries in which they operate define forest land rights clearly. Brazil’s flawed attempt to do this is a step forward.

Wall Street and the taxpayer

Thanks, for nothing

Jun 11th 2009
From The Economist print edition

Banks should be encouraged to pay back governments—but not to rewrite history

Illustration by S. Kambayashi



THERE is a new kind of queue in banking, and it is not formed of terrified depositors trying to withdraw their savings. Instead banks are lining up to repay the public capital they received during the depths of the crisis some six months ago. Having met regulators' stress tests, ten of America's stronger lenders, including JPMorgan Chase and Goldman Sachs, won approval on June 9th to buy back a collective total of $68 billion of government shares. In Britain, Lloyds Banking Group has begun to give the state some of its money back.

It is easy to see why the banks are keen. By reducing the government's stake they hope to reduce its influence. Paying back the state is also a way of advertising that they have regained some of their strength. In most respects taxpayers should be happy, too. With the financial system more stable and profits and share prices showing signs of life, these banks have been able to sell new shares to raise cash, and so replace state funds without eroding their capital. The returned money can be recycled into smaller banks which still need equity (see article) or used to cut public debt. It will be a long slog: Western governments have injected about $450 billion of capital overall. If the economy deteriorates again, investors' appetite for buying shares will evaporate. But the process of returning ownership of banks to the private sector has begun.

At the same time, however, a worryingly revisionist history of the credit crunch is being penned. It says that some banks did not really need government help and were bullied into accepting it last year as part of a wider bail-out of their flakier peers. There is a startling lack of grace: Jamie Dimon, the boss of JPMorgan, has fantasised about sending an ironic accompanying "Dear Timmy" thank-you letter to America's treasury secretary, Tim Geithner, saying "We hope you enjoyed the experience as much as we did." The boss of Wells Fargo has called the solvency tests "asinine". The aim of such behaviour is presumably to convince regulators to focus the coming clampdown on the weakest banks. JPMorgan argues that since it was forced into taking capital, the terms of the remaining warrants the government owns should "out of fairness" be eased. Other big banks make similar cases, albeit less vocally.

Despite owning hundreds of billions of dollars of hard-to-value assets, banks seem now to regard as unnecessary the American government's scheme to purchase toxic loans and securities. Those European lenders that did not get state capital are patting themselves on the back. The message is clear: we never needed government help, and we don't want it now.

2008 and all that

That is both wrong and dangerous. Wrong, because in the depths of the crisis the share prices and borrowing costs of all banks indicated an almost complete collapse in confidence. Some firms did perform better than others, but only relatively so. All the banks benefited from an implicit state guarantee. Even those lenders who never got capital would probably not have survived without government rescues of weaker firms to which they had counterparty exposures.

Similarly all banks are now plugged into government life-support systems. Their liquidity is supported by more generous collateral rules at central banks. Profits are being boosted by rock-bottom short-term interest rates. Some banks have managed to issue debt without public guarantees, but the system needs to refinance $26 trillion of wholesale funding by 2011; without an implicit state backstop this would surely be impossible. And the value of banks' assets is being sheltered by central banks' asset purchases and more generous accounting rules. The truth is that the West has a thinly capitalised banking system that is being allowed to earn its way back to health. Save for defence and space exploration it is hard to think of a privately run industry more dependent on the state.

So the revisionist version of the crisis is plainly inaccurate, but is it really dangerous? Yes, if it distorts the way new rules are drawn up to regulate banks. It would be a disaster if regulators adopted a two-tier approach, judging that those banks able to avoid or repay quickly state capital early had more or less vindicated their business models, and that only those unable to pay up required closer oversight. Although Barack Obama has said repayment does not imply “permission for future misdeeds”, banks with government stakes seem likely to be subject to different rules on executive pay.

If anything, regulators should focus not on the tardiest payers, but on those banks that are too important to fail. And the main bits of the reforms needed—more liquidity and capital, less proprietary risk-taking and better incentives—should be applied firmly and consistently to all lenders. It was the entire banking system, not a few individual firms, that failed. It is the entire system that must now be fixed.

Sri Lanka after the war

Victory's rotten fruits

Jun 11th 2009
From The Economist print edition

The government's unpleasant triumphalism is sowing the seeds of renewed conflict

Reuters



THE defeat of the Liberation Tigers of Tamil Eelam by the Sri Lankan army should be cause for almost universal celebration—whatever its manner. The foreign governments that had banned the Tigers as terrorists and from whose Tamil minorities some of the Tigers' funds had been extorted are glad to see them beaten. So too are Sri Lanka's Sinhalese majority, after a 26-year civil war. But Sri Lankan Tamils should also rejoice. They had borne the brunt of the Tigers' ruthless silencing of dissenting voices, of their pressganging of children and of the bloody consequences of their refusal to countenance any achievable political settlement. Yet the government of President Mahinda Rajapaksa is making even moderate Tamils at home and overseas feel its victory as their defeat.

In the third of his big set-piece victory speeches early this month, Mr Rajapaksa asserted that the war had been fought to liberate the Tamil people. Unaccountably, he made no reference to the sufferings of Sri Lankan Tamils even though nearly 300,000 of them have been displaced from their homes and are now miserably interned in camps. The president also harked back to ancient Sinhalese martial heroes. Marking victory with plans to build *stupas* all over the mainly Buddhist country, and relishing songs, posters and newspaper articles hailing him as a "king", Mr Rajapaksa seems to be cultivating the image of an elected monarch. In particular, he likes to recall Dutugemunu, a famous warrior-king of the second century BC, who defeated Elara, a Tamil usurper from India.

This foolish oratorical provocation has been matched by increasing intolerance of dissent, suspicion of many Tamils and threats against those seen as Tiger "collaborators". The government refuses to bow to calls for an independent investigation into the final weeks of the war, in which thousands are believed to have been killed by government shelling. It blames nearly all the civilian deaths on the Tigers. But in the absence of any inquiry a decades-old culture of impunity will persist, as will Tamil grievances and a sense of injustice.

This week a shipload of relief supplies for the displaced, sent by Tamil exiles suspected of Tiger sympathies, was turned back, even though the defence ministry conceded they had no "dangerous" intentions. The process of sending the displaced people home from the camps is painfully slow, partly because of the need to de-mine and rebuild their home villages, but also because of the fixation on weeding out Tigers hiding among the civilians. One-eighth of those interned are believed to be children. In light of the Tigers' record of deploying women and children as fighters and suicide-bombers, some caution is understandable. But little is being done to reassure moderate Tamils that the government cares for their plight. Conditions in the camps are no longer so critical, but there are too few toilets, and some have to queue five or six hours for their daily ration of water.

Meanwhile government ministers in Colombo mutter darkly about journalists and NGOs allegedly once in

the Tigers' pay. This encourages a freelance witch-hunt. On June 1st thugs abducted and beat up Poddala Jayantha, a journalist and activist. They have not been caught, but a fellow writer who alerted the police to the abduction was interrogated for hours. Scared, journalists have started to censor themselves.

No farewell to arms

Far from cashing a peace dividend by demobilising soldiers, the chief of the army has said he means to swell its ranks by 100,000, to 300,000—out of a population of just 21m. An already highly militarised country is to become even more so, with soldiers deployed everywhere to nip any reborn Tamil nationalist insurgency in the bud. In the "liberated" north local elections are to be held as early as August. Many will have to vote from the camps. Few will believe the process free or fair, seeing it, like elections in 2008 in the east, as a way of installing candidates in favour in Colombo.

Having made a strong case that it was liberating millions of its own people from the terrorist yoke, Sri Lanka's government seems to be doing its best to make those people feel newly oppressed. That is not the way to win reconciliation. It is a prescription for renewed rebellion.



On carbon taxes, Myanmar, Chevron in Ecuador, finance, MPs' expenses, guns

Jun 11th 2009
From The Economist print edition

Capping, not taxing

SIR – It seems out of step for *The Economist* continuously to advocate a tax on carbon when there is an overwhelming mandate from both industrialised and developing countries for a market-based system for negotiating the cost of emissions ("Cap and trade, with handouts and loopholes", May 23rd). Carbon taxes may seem seductively simple and fair in principle, but in practice they are neither. What you always conveniently leave out when promoting carbon taxes is that tax systems, more so than market systems, are prone to tweaks around the edges, giving free rides and special exemptions to favoured industries. The simplicity of taxes is their downfall; both the industries affected and their customers who ultimately foot the bill will cry foul.

By contrast, well-designed markets will promote rational "buy-versus-build" decisions. And although a taxation system will almost certainly create costs for industry, the level of reductions in emissions will be completely uncertain. Market-based cap-and-trade begins and ends with emission reductions.

In critiquing the first meaningful legislation in the United States on climate change it would have been nice if you recognised that this is part of a larger solution to solve a global problem. Implementing a system of transnational carbon taxes is fanciful—carbon taxes cannot be imposed across borders any more easily than, say, corporation taxes. A system of carbon markets is a realistic alternative.

Henry Derwent
President
International Emissions Trading Association (IETA)
Geneva

Ethan Ravage
Consultant to IETA
San Francisco

SIR – You injected a smoky haze of inaccuracy into the debate on climate change by describing the American Clean Energy and Security Act that is currently working its way through Congress as a "grand handout to shareholders". One aim of climate-change legislation is to reduce carbon emissions without harming the economy. The bill that emerged from the House energy committee goes a long way towards achieving that goal. It distributes a substantial portion of emission allowances to regulated, local distribution companies and helps to protect electricity customers from unnecessary price rises. Each and every dime of emission allowances granted will flow directly back to customers, not shareholders.

The House bill also avoids an unfair transfer of wealth from the Midwest and south-east to the coasts. The 25 states that depend on coal for more than half of their electricity are not punished with an immediate shock to their billing rates. These states will have the largest burden when it comes to reducing carbon from existing power plants. Older, inefficient coal plants will be retired soon and replaced with low-carbon solutions. Having to pay for emission allowances up front in an auction, as you suggest, while also having to pay for these new plants would be a double blow for customers.

Auctioning emission allowances at an average price of $20 a ton, as proposed recently by the White House Office of Management and Budget, would have caused rates to rise immediately and increased customers' bills. The OMB plan was not really a climate plan, it was a revenue-raising plan. Some 85% of the $650 billion raised from auctioning emission allowances would have gone to programmes that have nothing to do with climate change. Only 15% was slated for clean-energy research and development. The clean energy act changes the focus back to reducing emissions. That's the right way forward.

Keith Trent
Chief strategy, policy and regulatory officer
Duke Energy
Charlotte, North Carolina

Punitive (non)action

SIR – You presented only a partial picture regarding sanctions against Myanmar ("The isolation ward", May 23rd). The sanctions imposed by America and Europe have been ineffective because Myanmar's neighbours, particularly Thailand, China and India, are eager to do business with its ruling generals.

You also suggested that sanctions are partly to blame for Myanmar's economic woes. I would argue that rather than being just one factor, the overriding cause of its poverty is economic mismanagement by the State Peace and Development Council. For example, the regime spends less than 2% of its budget on health and education combined and 50% on the military, which seems more concerned with crushing pro-democracy groups than with any external threat.

Rana Siu Inboden
London

An oil company in Ecuador

SIR – Your article on the lawsuit against Chevron in Ecuador misses important facts ("Justice or extortion?", May 23rd). Between 1964 and 1990, Texaco, now Chevron, dumped billions of gallons of toxin-laden formation water into the streams, rivers and forests of the Amazon, creating what our experts believe is the worst oil-related contamination on the planet. Unlike the *Exxon Valdez* or *Prestige* oil-spill disasters, this dumping was no accident; we believe that it was designed to expel waste to a sensitive ecosystem where indigenous groups had prospered for centuries.

Contrary to what you suggest, the law used for the substantive claims of the case is not a new environmental law being applied retroactively but is based on provisions of the Ecuadorean civil code dating to the late 19th century. The lawsuit targets Chevron because Texaco designed, built and operated a system of oil extraction that produced toxins that will cause harm for centuries unless remediated.

The article also fails to note that when Texaco and then Chevron fought for nine years to block a trial in federal court in the United States, they submitted numerous sworn affidavits praising the fairness of Ecuador's judicial system and agreed to be bound by any ruling in Ecuador. Now Chevron is attacking the very courts it had praised.

Steven Donziger
Lawyer representing Amazonian communities in legal action against Chevron
New York

Financial terms

SIR – I must be a Luddite. I wince when I hear the word "innovation" used in finance, as if bankers are on a par with those who found cures for diseases, invented the internet or decoded the human genome (Special report on international banking, May 16th). They are not. Much of what passed as financial innovation in recent years and which helped trigger the near-collapse of the financial industry, such as collateralised-debt obligations, was little more than an ingenious sleight of hand. A global economy needs the efficient movement of money. Bankers can help provide this, but let's not indulge their hubris.

James Schofield
The Hague

* SIR – You shied away from the proposal that governments should limit the size of banks, so that any one failure does not endanger the whole system. Banks must not be allowed to become "too big to fail", and this requires state intervention. Regulators could implement a system that prevents the rise of another

multinational megabank, the failure of which would require more billions of dollars in a bail-out, a costly moral hazard.

As you say, banks are a part of society's well-being. The one silver lining that may emerge from this crisis would be if governments recognised this and protected society from the impact of future failures, which are inevitable if the current banking model is only tinkered with in the way you recommend.

Moorad Choudhry
Head of treasury
Europe Arab Bank
London

* SIR – Your article on the world's best banks ("A short list", May 23rd) did a great disservice to Canada and Australia by not recognising them as two outstanding examples of countries with well-managed, conservative banking systems, and which have both survived the recent crisis relatively unscathed. All the big Canadian and Australian banks were recently listed in "The World's 50 Safest Banks 2009" in *Global Finance* magazine. That is more than can be said for America and Britain.

Peter Grierson
Ridgefield, Connecticut

Give them a moat, if need be

* SIR – A simple and effective way to ditch the whole parliamentary expenses system is to give the responsibility of paying for the upkeep of members of Parliament back to the people who elect them in the first place: their constituents ("Moats and beams", May 16th). Each constituency could scrutinise the expenses of its own MP. If an MP does a good job he will not only be re-elected but maybe even given a bonus to fly rather than take the train to London. And if constituents decide to put their MP in either a luxury apartment or a poxy bedsit, it becomes their problem and no one else's.

Demissie A. Demissie
Addis Ababa, Ethiopia

* SIR – Bill Gates once suggested in a withering putdown of his competitors that they suffered from finite greed. Reading about the details of the expenses scandal surrounding MPs, Mr Gates should think himself lucky that he never came up against Britain's inventive politicians in market competition.

John Johnston
Glasgow

A sharpshooter

SIR – A fitting endnote to your recent articles on regulating firearms could have come from the late Jack Kemp, whose razor-sharp wit you rightly praised ("Conservative hero", May 9th). When asked where he stood on the issue, the Republican replied, "my idea of gun control is a steady aim."

Robert Gentle
Johannesburg

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*Letter appears online only

The Amazon

The future of the forest

Jun 11th 2009 | MANAUS
From The Economist print edition

Brazil's government hopes that land reform in the Amazon will slow deforestation. Greens doubt it

Still Pictures



THE tiny village, where naked Ticuna Indians live in wooden houses raised on stilts, looks out over one of the rivers that becomes the Amazon. No place seems farther removed from the ups and downs of the world economy. But this is misleading. The Ticuna, who now have a large reservation at Novo Paraíso near Brazil's borders with Colombia and Peru, took their first steps towards globalisation when they had the misfortune to encounter Portuguese raiders several centuries ago. Later, rubber drew the Amazon into the list of hinterlands that could be tapped if supplies were tight elsewhere, allowing growth to accelerate in much of the world from the 19th century onwards. And today new demands on the Amazon's riches will determine the future of the forest.

About 900 miles (1,500km) downriver to the east, in Amazonas state, stands Manaus. Rubber barons built the city from the 1860s onwards. Its early residents made up for their distance from the European centres of fashion by trying to outdo Paris during the *belle époque* in drinking and debauchery. Now Manaus's Zona Franca is the workshop for most of the televisions, washing machines and other white goods sold in Brazil. Special arrangements allow firms such as Sony and LG to import parts tax-free from elsewhere in the world and assemble them there. Despite being surrounded on all sides by thick forest, Manaus hums with manufacturing.

Some 350 miles to the south-east, in Pará state, the high gold price has encouraged a few hundred *garimpeiros*, or wildcat miners, to follow rumours of a strike and trek for days through the forest to a place, not far from Itaituba, which they have optimistically named "Bom Jesus". They live in shacks with tarpaulins to keep off the rain, digging square holes and sifting through the red soil in the hope of finding a seam of gold. Malaria lurks there, and the men say there is cyanide in the water. Apart from a visiting government minister and some other dignitaries and journalists who have come for the day by helicopter, there is nothing to indicate that the Brazilian state exists. Its place has been taken by a local boss who claims to own the land (though it actually belongs to the federal government) and takes a percentage of any gold found, while charging the workers exorbitant prices for supplies that are dropped off by small planes.

South by 400 miles, in Mato Grosso state, the Amazon meets the agricultural frontier. Much of the world's growing demand for protein is satisfied here. The state, which was once thought to have poor farmland, has

been transformed over the past few decades and is now the country's biggest producer of soyabeans for vegetable oils and cattle-feed. Mato Grosso is also home to an unproductive kind of agriculture, which involves ranching small numbers of cattle on newly deforested land. The forest in the state shrank by 105 square miles in the three months from November to January, according to the Brazilian Space Research Institute, which uses satellites to monitor deforestation.

All these places are part of the Amazon rainforest, an area one-and-a-half times the size of India, or nearly eight times the size of Texas. Most of it lies within Brazil. It is home to 20m Brazilians, or 10% of the country's population. Many of them live a hardscrabble existence in places that are hot, wet, often disease-ridden and sometimes dangerous. These people have gone from being heroes who answered the government's call to populate and subdue an empty region, to environmental criminals who are wrecking the planet, all the while standing on the same spot and doing what they have done for decades.

No government would think of condemning so many voters to persistent poverty in the name of saving trees. Moving them is impractical and would be unjust, since the state moved them in the first place, under a policy that began in the 1960s and lasted for 20 years. (Other institutions helped too; the World Bank provided a loan that financed a large migration from the south of the country to Rondônia state in the days before it cared about greenery.) A vast migration was accomplished with promises of free land, subsidies and a slightly menacing marketing campaign that exhorted people to *ocupar para não entregar* ("occupy it or lose it"). Parts of Brazil's government still fret that covetous foreign powers may try to annexe the Amazon forest unless the country can find something useful to do with it.

President Luiz Inácio Lula da Silva's government has often seemed to sympathise more with these voters than with environmentalists, who are anyway politically weak in Brazil. His first environment minister, Marina Silva, resigned in frustration last year. This pleased the *bancada ruralista*, an informal block of representatives who defend agricultural interests. They were glad to see the back of Ms Silva, the daughter of rubber-tappers who grew up in the forest and became the most eloquent spokesman for the need to preserve it. This agricultural lobby makes up 20-25% of Congress, according to João Augusto de Castro Neves, a political consultant.

Fires, grass, cattle

To improve the lives of Brazilians living in the Amazon, the government has devised a set of policies known as Plano Amazônia. They envisage an expansion of road-building in the forest, as well as some big hydroelectric projects. Both are loathed by people who want to preserve the trees. Plano Amazônia also contains measures to slow deforestation, but these will be hard to enforce. Money is short, the area to be policed is vast, and the folk who make money when the trees are cut down are endlessly ingenious.



Many people derive their income from deforestation. In Tailândia, a town in Pará surrounded by sawmills, some 70% of the population depends on logging in some way, according to local officials in the state's finance ministry. The loggers work in tandem with cattle farmers: once the loggers take the best trees from

an area, the rest is cleared and burnt. The farmers then sow grass and raise cattle. The land is quickly exhausted as pasture, but it then passes to another type of farming, while the loggers and cattle move farther into the forest and begin all over again.

This pattern helps to explain why the rate of deforestation tends to move with prices for beef and soya, with a lag of about a year. Yet it is a wasteful way of using land. A recent study of some 300 municipalities in the Brazilian Amazon, published in the latest edition of *Science*, shows that deforested areas enjoy a short economic boom, then quickly fall back to previous levels of development and productivity as the frontier moves on. Deforestation also, of course, reduces the rainfall on which Brazil's agriculture depends.

Consumers in America and western Europe who mind about deforestation may think they have some influence over all this. A recent study by Greenpeace encouraged them, by trying to show that bits of Amazonian cow were finding their way on to supermarket shelves in the rich world. They are wrong, however. The five leading markets for Brazil's enormous beef exports (the country ships more of it than the total of the three next-largest exporters, Australia, Argentina and Uruguay) are Russia, Iran, China, Venezuela and Egypt, according to Roberto Giannetti da Fonseca of the Association of Brazilian Meat Exporters. And in any case the beef produced in the Amazon is mostly eaten by Brazilians in neighbouring states.

Even so, Mr da Fonseca says his association would like to see cattle-ranching removed from the Amazon, because of the damage it does to the reputation of exporters. The big soyabean exporters have already pledged not to buy from growers in the Amazon. Greenpeace, which helped to design the agreement, counts it as a success. This just leaves an internal market for cheap soyabeans and beef, which supports 30m head of cattle in the Amazon out of a total of 200m in the country.

Given the hardships that farmers in the Amazon face, it may seem surprising that they do not just give up. One reason is that clearance and cattle bring in extra money from other sources. The farmers are also property developers of a kind. Jungle land can be grabbed for nothing, avoiding what is normally a huge outlay in farming. And ranchers often sell the land they have deforested to another user, even though they do not legally own it. Most people who study deforestation reckon this creates an incentive for farmers to push farther into the forest, rather than staying where they are, spending money on improving their land and raising productivity.

Ending this cycle is one aim of a land-reform bill that was recently approved in Congress, though not without controversy. This law is now with the president, who has the power to veto some of it. The government claims that the legislation will at last enable it to discover which farmers are operating on illegal land and in the informal economy, and in the future will make it possible to work out who is committing environmental crimes. Many environmentalists, however, think the law merely rewards criminal behaviour. Ms Silva has appealed to Lula to use his veto.

Get off my land

Holdings in America's Great Plains, impressively neat and rectilinear from the air, were laid out in various early land laws and then parcelled out among pioneers. Brazil's frontier has never benefited from such an elegant application of geometry. A study from Imazon, a non-profit research outfit, suggests that just 14% of privately owned land in the Amazon is backed by a secure title deed. The rest is covered by fake documents (usually lovingly antiqued) or simply by right of settlement.

In the most contested parts of the forest, in Pará state, conflicts over who owns what are sometimes settled with a gun. In 2005 the murder of Dorothy Mae Stang, an American nun and environmental campaigner who lived in Pará, brought this to the attention of a wider public. In his trial, the man who pulled the trigger said he had been paid 50 reais ($20) for the job.

Eyevine



Tranquillity on the river

There are still gunmen for hire in Pará, according to the police in Tailândia, a town of 25,000 people. Rosenildo Modesta Lima, the local police commander, says that when he arrived there a couple of years ago there were seven murders over one weekend; now there are two or three a week. The police are on edge. Just the other day a heavily armed gang attacked a police station in a neighbouring town in an attempt to get more weapons. Two gang members were killed and a third injured.

The new law will interpose the Brazilian state into this mess, judging between competing claims, handing smaller plots of land to their apparent owners and reclaiming very large ones (in excess of 1,500 hectares or 3,700 acres) for the state. This will undoubtedly entrench some old injustices. "It's very hard to know who killed someone 20 years ago to get a piece of land and who just arrived recently," says Denis Minev, the planning secretary for Amazonas state (which has a good record on deforestation). Even so, in the long run the measure may prove useful. "Land regularisation is of fundamental importance for halting deforestation," says Carlos Minc, Brazil's environment minister.

Enforcing the new regime will be as difficult as ever. IBAMA, the federal agency charged with this task, collects less than 1% of the fines it imposes during operations in the Amazon. "This is not something that is feared as a serious threat by people who break the law," says Roberto Smeraldi of Amigos da Terra, an NGO. The sporadic weakness of the Brazilian state is partly to blame for this. But any government would struggle to police the frontier between forest and farmland, which is far longer than America's border with Mexico.

This is why many environmentalists now argue that the only way to fix the problem is to give people who live at the frontier something more profitable to do. The government has begun to change the region's economies. Since July last year farmers without titles to their land are supposed to be denied access to subsidised credit, though this too is hard to enforce.

Efforts to commercialise forest products, from Amazon river fish to oils for use in cosmetics, are also under way. Amigos da Terra, in a study of these businesses, finds them to be profitable when they form clusters and turn out finished products. "I am convinced that in 20 years we will have a viable forest economy," says Mr Smeraldi. "Only by then we will have lost a lot of forest."

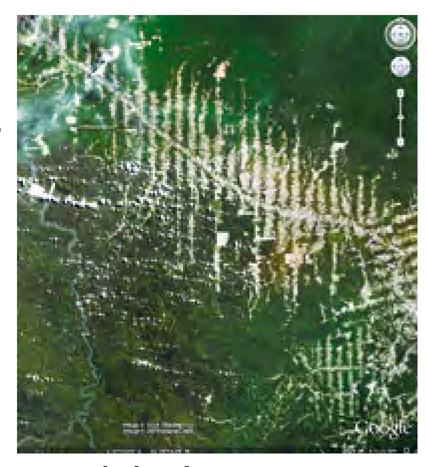
Speeding up this process is one of the motives behind the $1 billion donation for the Amazon announced in September by Norway's government. The Brazilian government has set up an Amazon Fund for this money and any future donations. Norway will have no say in how it is used, but the amount of money it releases from the fund will be linked to Brazil's success in slowing deforestation. Germany will give something to the fund too. Turid Rodrigues Eusébio, Norway's ambassador to Brasília, says lots of other countries are watching Norway to see how the experiment goes, and will chip in if it is a success.

Google Earth

Amazon states hope to acquire another stream of money, in the form of payments for not cutting down trees, from the UN initiative known as REDD, which will be discussed in Copenhagen in December (see article). Payments of this kind are already being made in Amazonas state: $8.1m from private companies such as Marriott hotels and Bradesco, a big bank, is being handed over by the state government to 6,000 families in exchange for not cutting down any more trees. The challenge is to extend such schemes to the trees on the edge of the farmland, which are most at risk.

Still, argues Ms Rodrigues Eusébio, it will take more than changing cattle-

ranchers into nut-gatherers to put a stop to deforestation. To bring a more elevated form of economic development to the region, Brazil's government is convinced that it needs to build more roads in the forest. This too is controversial. Some 80% of deforestation happens within 30 miles of a road. Seen from Google Earth, the southern part of Pará state looks as if someone has dropped large fish skeletons on the jungle, as spines of deforestation push into the trees from either side of the roads. Deforestation is more severe where a road is good, which is why the proposed asphalting of the BR-163, from Cuiabá in Mato Grosso to Santarém in Pará, is held up by a legal wrangle.



Depredation from space

However unpalatable road-building is, it may be needed if the people who live in the Amazon are to lead a better life. "The Everglades are very beautiful, but America did rule out building roads through them to connect Miami with other parts of Florida," says Mr Minev of Amazonas state. The government now knows how to build roads without unleashing the loggers, he argues. Amazonas has recently signed an agreement creating nature reserves on either side of the BR-319, which runs from Manaus to Porto Velho. The road will help to integrate Manaus into the rest of the country's economy. When the Zona Franca was established in 1967, it took 15-20 days to get goods to consumers in São Paulo, in the country's south-east. It takes the same amount of time today.

In this vision of the Amazon, the forest will be preserved as a large national park with sprinklings of industry added to enrich its inhabitants. The agriculture at its edge will be more productive than it is today, making use of abandoned land and raising yields to meet domestic and foreign demand without encroaching farther into the jungle. This is aim is plausible, as well as commendable, but it will take decades to accomplish. In the meantime, the forest will continue to shrink. The fight today is over how fast that happens.

Oil and land rights in Peru

Blood in the jungle

Jun 11th 2009 | LIMA
From The Economist print edition

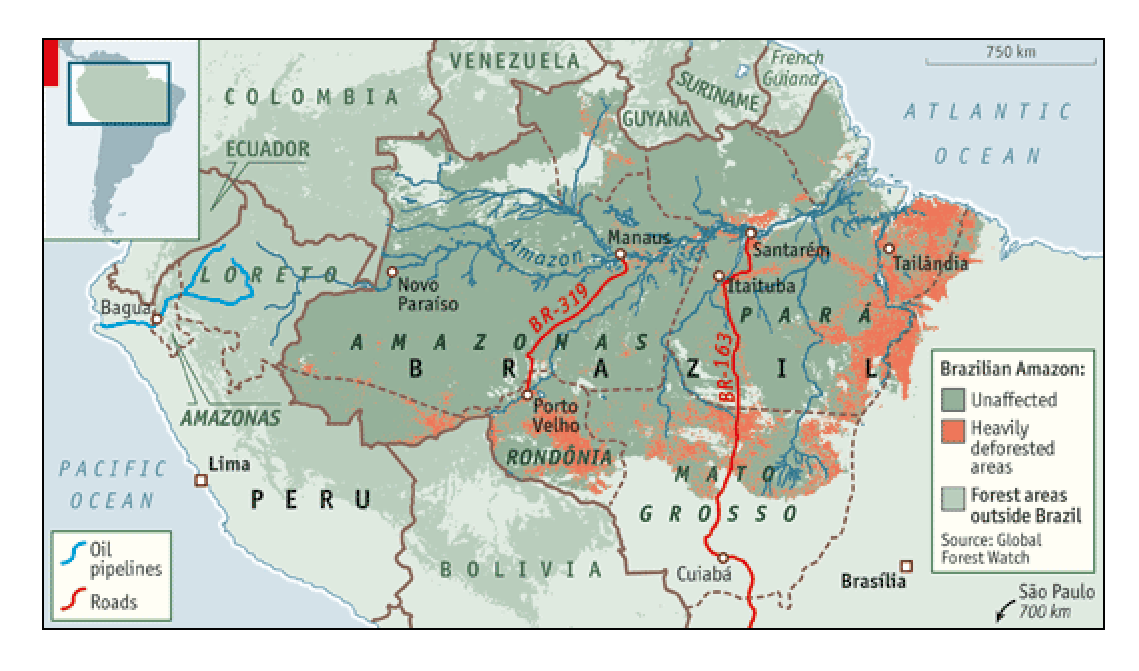
Alan García's high-handed government faces a violent protest

EPA



FOR seven weeks tens of thousands of Amazonian Indians blocked roads and rivers across eastern Peru. They seized hydroelectric plants and pumping stations on oil and gas pipelines to try to force the repeal of decrees facilitating oil exploration, commercial farming and logging in parts of the jungle. Petroperu, the state oil company, had to shut a pipeline that carries 40,000 barrels of oil each day. Amid threats of energy rationing in eastern towns, the government of President Alan García this month ordered armed police to clear a stretch of road and retake a pumping station near Bagua, in Peru's northern jungle (see map).

In the ensuing clash at Curva del Diablo—or "Devil's Curve"—on June 5th at least nine protesters and eleven police were killed. The Indians, armed with spears and machetes, went on to capture and kill a dozen more police guarding a pumping station. Their leaders claim that at least 40 Indians were killed and 60 more are missing, though these numbers have not been confirmed.



This bloody confrontation has rocked Mr García's government—and dramatised the failure of Peru's political system to settle the conflict between the government's plans for development and the demands of some of

its poorest citizens.

Thousands of Indians brandishing wooden spears continued to block roads near Bagua this week. The government imposed a curfew and placed the army in charge of two provinces in Amazonas department. It has sent police reinforcements to other parts of the jungle and ordered the arrest of Alberto Pizango, the leader of AIDESEP, an umbrella-group of jungle-Indian peoples that organised the protests. Mr Pizango last month briefly called for an “insurgency” against the government, raising alarm in a country that suffered greatly from the terrorist violence of the Shining Path in the 1980s and 1990s. He has sought and been granted asylum in Nicaragua. Mr García has hinted that radical socialist governments in Venezuela and Bolivia were behind the violence, and were manipulating “ignorant” Indians.

While not endorsing AIDESEP’s violent tactics, many Peruvians blame Mr García for the violence. *El Comercio*, Peru’s establishment newspaper, echoed opposition calls for the sacking of Yehude Simon, the prime minister, and of the interior minister for bungling the dispute. The government is widely condemned for failing to consult properly over 99 decrees it issued a year ago, using legislative powers delegated by Congress. These decrees were ostensibly designed to speed the implementation of a free-trade agreement with the United States, but trade had little to do with the new rules that AIDESEP objects to.

After a first wave of protests by AIDESEP last August, Peru’s Congress repealed two decrees which would have made it easier for Indian communal lands to be sold. But congressional leaders failed to conduct a promised review of eight other decrees, prompting a renewal of protests in April. These measures introduce provisions allowing the development of “unproductive” land in the jungle. The recent blocking by Mr García’s APRA party of an attempt to repeal one of the eight measures, the forestry and wildlife law, triggered the violence. However, on June 10th Congress voted to suspend temporarily two of the decrees.

Mr García argues that the Indians should not be allowed to block investment in oil and gas that he hopes will turn the country into an oil exporter, benefiting all Peruvians. AIDESEP counters that his decrees ride roughshod over the property rights of the Indians. Peru has some 70m hectares (173m acres) of rainforest—the largest chunk of the Amazon basin outside Brazil. Around 70% of the jungle has now been granted, or offered, as concessions for oil and gas exploration, much of it by Mr García’s government. Foreign oil companies, including Spain’s Repsol, and dozens of smaller outfits, are operating many of these concessions.

Much of the land is claimed either as communal by Indian tribes or as private property. One hotly disputed area involves Lot 67, a concession in Loreto in the north-eastern jungle. Perenco, an Anglo-French company, plans to invest up to $2 billion by 2013 to extract 100,000 barrels per day of heavy oil. This partly overlaps a proposed reserve for an Indian tribe that eschews contact with the modern world.

AIDESEP complains that governments have been slow to settle Indian land claims and grant titles, and quick to grant concessions to oil companies and loggers. This makes Indians suspicious and resentful. Some 330,000 of them, grouped in 60 different tribes, live in the Peruvian jungle (where they make up 10% of the population). Many have not joined the protests. Most lack adequate schools and health clinics. More than half the population of the northern jungle is poor, compared with a national average of 36%.

Peru has seen many conflicts between foreign mining and oil companies and local people, who complain of environmental damage and/or a lack of tangible benefits from these investments. The conflicts are often resolved only after protests, and sometimes bloodshed.

AIDESEP says that under the UN declaration on indigenous peoples, which Peru voted for, its member groups have the right to exercise control over their traditional lands and their resources. The problem for Peru is that there is no agreement about how to apply such rights or how to square them with the interests of the rest of the population. Force is not the answer. Instead of bluster, Mr García should be offering Peru proper consultation and vigorous debate about these issues.

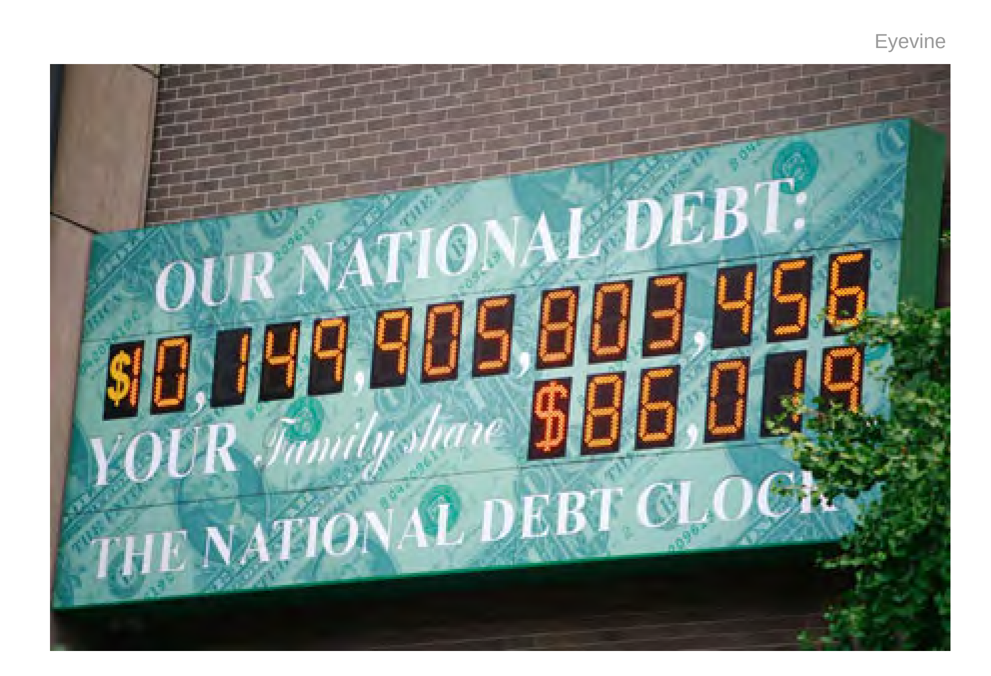
The politics of debt

Seeing red

Jun 11th 2009 | WASHINGTON, DC
From The Economist print edition

America's debt is Barack Obama's biggest weakness

Eyevine



"PAYING for what you spend is basic common sense. Perhaps that's why, here in Washington, it's been so elusive," said Barack Obama on June 9th. He was urging Congress to pass a new "pay-as-you-go" (PAYGO) plan that would oblige it to pay for new spending either by raising taxes or by cutting outlays. By following the same principles that guide "responsible families managing a budget", he said, Americans could dig the country out of the "very deep hole" that "the reckless fiscal policies of the past have left us in".

Republicans marvel at his skill in stealing their clothes. Democrats retort that, under George Bush, Republicans left their clothes unguarded while they cavorted in a hot tub of borrowed cash. Sure, they talked about fiscal responsibility. But instead of choosing between tax cuts, wars and social spending, they chose all three—and left the bill for future generations.

Whenever Republicans accuse Mr Obama of fiscal profligacy, Democrats have three easy answers. The first is to accuse them of hypocrisy—why did conservatives not speak up when Mr Bush was splurging red ink? The second is to blame all fiscal problems on Mr Bush. The third is to argue that although Mr Obama's deficit is large, it is a needed and temporary response to an emergency. In this deep recession only the government can prop up demand and fend off economic disaster.

Yet budget hawks are far from reassured. Bad as the deficit was under Mr Bush, it will quadruple this year, from $459 billion in 2008 to $1.85 trillion (from 3.2% of GDP to 13.1%), according to the non-partisan Congressional Budget Office (CBO). Mr Obama vows to halve it within four years, but that will still leave it bigger than the deficits for which he once lashed Mr Bush. Mr Obama's aides hint that he will get tough when the time is right, but he is reluctant to break campaign promises of tax cuts for all but the rich just yet. The CBO reckons the deficit will still be running at more than $1 trillion a year in 2019 (see chart). It estimates that the accumulated debt will have hit almost $19 trillion by then. Yet it was only last October (see picture above) that it breached $10 trillion, requiring an extra digit to be added to the famous debt clock off Times Square.

All such projections are tentative, of course. The bank bail-out could cost less than expected. Health-care reform could cost more.

Congress seems determined that a proposed cap-and-trade system for carbon emissions, which Mr Obama was counting on to raise hundreds of billions of dollars, will raise only a fraction of that. A faster-than-expected economic recovery could restore the national balance sheet to something resembling health. A sluggish one could rip it to shreds.



Sceptics fret that PAYGO will do little to address the deficit because it has four big loopholes. The rules will not apply to the annual "patches" passed to lessen the impact of the Alternative Minimum Tax, a levy originally aimed at rich tax-dodgers but which now ensnares millions of middle-class Americans. Also exempted are Mr Obama's planned extension of many of Mr Bush's middle-class tax cuts, modifications to the estate tax and some increases in payments to doctors by Medicare (the public health plan for the elderly). Those exceptions would add $2.5 trillion to the deficit over ten years, reckons Maya MacGuineas of the Committee for a Responsible Federal Budget, a non-partisan watchdog. "This is like quitting drinking, but making an exception for beer and hard liquor," she says.

Meanwhile, the long-term fiscal outlook grows ever grimmer. Americans are getting older. The government's unfunded obligations to give the elderly pensions and health care are equivalent to a debt of $483,000 for every household. Some find this alarming. Peter Peterson, a private-equity billionaire, is spending most of his fortune trying to educate the public about the perils of fiscal incontinence. The wave of "tea party" protests that swept the country on April 15th was evidence that plenty of voters are worried.

Republicans think they see an opening. Although Mr Obama is still very popular—his approval rating is 67%—Americans have doubts about his fiscal stewardship. In a recent Gallup poll, 51% disapproved of his handling of federal spending. Since this is the only area where most people disapprove of Mr Obama, Republicans are enthusiastically prodding it.

"There's going to come a point where it's going to be impossible to get people to buy our bonds at affordable prices," says Paul Ryan, the leading Republican on the House budget committee. He fears that the Democrats will create a huge new spending programme—a national health-care plan—while making little effort to curb spending in other areas. That, he predicts, will lead to crushing taxes on middle-class Americans, a lower standard of living and higher unemployment.

Mr Ryan offers brave and obvious proposals to fix the budget, such as raising the retirement age. Most of his Republican colleagues, however, prefer not to be pinned down. When asked for specific examples of what they would cut, they tend to waffle about waste and fraud. This week Newt Gingrich, a former speaker of the House of Representatives, boldly came out against dodgy claims for disability payments by railway workers on Long Island.

Politically, it makes sense to pick on soft targets. Americans stopped trusting Republicans with their money in part because some conservatives were caught trousering bribes or peddling influence. Now that Democrats control Washington, the sleaze is more likely to be Democratic.

Thus Republicans are making much of the fact that Barney Frank, the Democrat who heads the mighty House financial-services committee, somehow persuaded the government-owned General Motors not to shut a factory in his district. Firms linked to Jack Murtha, a Democrat notorious for earmarking funds for his home town, are under investigation.

So far, there is little sign that Republican attacks on Democratic profligacy have had much bite, says Stuart Rothenberg, a political analyst. But he thinks that the longer they are out of power, the more their message will resonate. The Democrats have only a brief chance to show they are serious about putting America's finances in order. The bond market will punish them if they fail, and the voters will follow suit.



The decennial census

The knock on the door

Jun 11th 2009 | NEW YORK
From The Economist print edition

Preparations for the 2010 census are under way. So are some rows

U.S. Census P.I.O



Scratching the ten-year itch

“IT’S not the voting that’s democracy; it’s the counting,” wrote Tom Stoppard, a British playwright. Months after voting in a new president, America is readying itself for another big effort: counting every American. The census, required every ten years by the constitution, will determine the distribution of congressional seats and $3 trillion in federal funds over the next ten years. The 2000 census is said to have been the largest peacetime mobilisation in American history. The 2010 census will be larger.

To count every man, woman and child in a country as large as America is no easy task. The next census is expected to cost $14.5 billion, up from around $8 billion in 2000 and $4 billion in 1990. The Census Bureau has already hired 140,000 people to walk around checking all addresses so that the census form, which asks ten questions about matters such as marital status, race and the number of people in a household, can be sent out next March. Over a million employees will be needed next year to go door-to-door and track down people who did not return their form.

State and local governments are readying their publicity machines. The recession means that states need as many federal dollars as they can get to pay for roads, social services and education; population is a big factor in divvying out the cash.

The political ramifications of the census are huge as well. Several states in the north-east and Midwest have lost population, and will probably lose seats in the House of Representatives (and electoral-college votes) to states in the South. Texas could gain as many as three seats.

Drawing attention to the census is especially important in cities and counties with lots of people who are hard to count. Illegal immigrants, the poor, the homeless and minorities all have high non-response rates, which means that the places where they live do not get all the money they are entitled to. More than 3m people are thought to have gone uncounted in the 2000 census. New York City alone is thought to have lost out on about $850m.

Illegal immigration poses a particular challenge. The Census Bureau asks everyone to take part in the census, regardless of immigration status. It is an uphill battle, however, to convince illegal immigrants that they are safe sending their name and personal information to the government.

The debate over how to count all Americans was reignited in April when Barack Obama nominated Robert

Groves, a former Census Bureau official, as census director. In the 1980s Mr Groves supported the use of statistical sampling to estimate how many people the census misses. Republicans objected loudly: it is widely presumed that most hard-to-count people vote Democratic. Mr Groves has pledged not to use sampling in 2010. And plans are afoot to turn the bureau into an independent agency, in the probably vain hope that this would free it from politics.

Poor Mr Groves will have his hands full. The recession will make counting people next year even harder than usual. Foreclosures and job losses have caused people to move, and homelessness is up. But at least, thanks to the large number of jobs it is (temporarily) creating, the census may help lift the economy a bit.



The Caperton v Massey case

Not for sale

Jun 11th 2009 | CHICAGO
From The Economist print edition

Limiting money in America's courts

WHAT happened in West Virginia would have been unthinkable in most other countries. In 2004 Don Blankenship, the chief executive of Massey Energy, spent $3m to help elect Brent Benjamin to the state Supreme Court. Three years later Mr Benjamin voted to overturn a $50m claim against Massey. The case is an extreme example of an American reality. Thirty-nine states elect at least some of their judges: so although judges do not have constituents, they have contributors. On June 8th the Supreme Court in Washington, DC, decided by five votes to four that the West Virginia case went too far.

This is the first time that the distinguished justices have ventured into the muddy business of money in judicial elections. Hugh Caperton, whose firm was allegedly bankrupted by Massey through fraud, argued that he had been denied a fair trial. The Supreme Court agreed, with Anthony Kennedy writing that Mr Benjamin's failure to recuse himself had created an unconstitutional "probability of bias". *Caperton v Massey* is a first step on a long and bumpy road.

Judicial elections have got rougher. Trial lawyers and business groups—and Democrats and Republicans—have seized on judges as weapons in their wars. Between 2000 and 2007 state Supreme Court contests raised $168m, more than twice the amount raised in the 1990s. But despite all that money, it is usually left to judges themselves to decide if there may be a danger of bias, and to remove themselves if there is. And some do not.

Caperton will at last set a constitutional ceiling on this rising frenzy. The court ruled that the scale of Mr Blankenship's spending (300% more than Mr Benjamin's campaign) and its timing (as Massey waited for an appeal) should have required Mr Benjamin to step aside.

AP



Benjamin judged himself innocent

Yet much uncertainty remains. The dissenting justices listed 40 troubling questions. How much money is too much? Are judges biased against those who opposed their election? How long does a probability of bias last? What about spending not by an individual but by a group?

Resolving such questions is still a matter for the individual states. Rebecca Kourlis, a former member of Colorado's Supreme Court, thinks judicial elections should be scrapped. This will take time. Amending a state's constitution is a slow process, and even though most Americans believe contributions influence courts, they still prefer judicial elections to appointment or nomination by committee.

If elections are to remain, states can at least try to fight their most pernicious effects. Tightening rules for recusal would help, says James Sample of New York University's Brennan Centre. An independent commission, for instance, could decide whether a judge should step aside. Mr Benjamin found he was unbiased after deliberating with himself.

Some states are considering reform. *Caperton* may encourage them. The ruling saved courts from a free-for-all, but there is still plenty of room for confusion.



Rural health reform

Small steps

Jun 11th 2009 | HAZARD, KENTUCKY
From The Economist print edition

Navigating health care's labyrinth

RURAL Kentucky, and particularly eastern Kentucky, is poor and relatively unhealthy. The people who live in the hills and hollows of central Appalachia face high rates of diabetes, heart disease, cancer and respiratory illness. Some of the area's problems are common across America: many rural Kentuckians are uninsured, for example, which discourages them from seeking preventive care. Other hazards are distinct to the area. Walking can be a dangerous form of exercise, with oversize log and coal trucks barrelling down the twisty mountain roads. Some people live without running water, or in homes heated by kerosene. In any of these cases, people could do with a local expert to help them navigate the labyrinthine American health-care system.

That is the idea behind Kentucky Homeplace, run by the University of Kentucky. The programme employs about 40 "lay navigators" who work in the poorest parts of Kentucky helping people figure out what they need and how to get it. In one case, Homeplace helped a steelworker who broke his arm on a day off. He had no health insurance to begin with and, after the injury, no income. Homeplace workers negotiated the price of the surgery, and persuaded a hospital to lend a free room. "You can't let a man go around with his arm broke," explains Fran Feltner, the director of the programme.

She describes another case, of an elderly couple. The husband was ill, and relied on his wife to keep his medications sorted. But her eyes were clouded with cataracts, and one day she mixed up his pills. He would have gone to a nursing home, but Homeplace intervened: if the state could arrange for the wife to have her cataracts removed, he could go on living at home. That was better for the couple and, as Ms Feltner notes, saved the state a bundle in long-term care fees.

The pragmatic approach has proved effective. In its 2007-08 budget year, Homeplace served 13,000 clients. According to its data, it helped them get $26m-worth of free prescription medicines alone: not bad, on a $2m annual budget. In 2008 the National Rural Health Association recognised Homeplace as the Outstanding Rural Health programme of the year. So its supporters were surprised when the state decided to slash Homeplace's funding by $750,000 some months ago. Kentucky is facing a serious budget shortfall, but the cut halted the programme for about four months. And the timing was bad, because as the economy worsened more people were calling Homeplace for help.

Fans clamoured for funding to be restored, and in May the *Louisville Courier-Journal* ran a long article about the problem. Days later, the state announced it would come up with the money for the rest of the year. That is good news for some of Kentucky's poorest people.

As more states find themselves in financial straits, such programmes will remain vulnerable. At the national level, though, experts on rural health see cause for optimism. Barack Obama's budget increases regular funding for schemes such as the National Health Service Corps, which helps people through medical school if they pledge to practise in underserved areas. The stimulus package also includes billions of dollars for dozens of rural and community health programmes. The benefits may even spill over beyond rural areas to the rest of the country. The Health Resources and Services Administration, a federal agency, has its own "lay navigators" programme. It is working in Brooklyn and in greater Los Angeles.



Cracking down on illegal immigration

The Missouri way

Jun 11th 2009 | ST LOUIS, MISSOURI
From The Economist print edition

A powerful precedent is set

VALLEY PARK, a small suburb of St Louis perched on the banks of the Meramec river, seems an odd place for a fight over illegal immigration. Although there are surely some illegals about, as there are in most parts of America, there is no visible community of outsiders or labour-intensive industries to lure them. But since 2006, when Valley Park passed legislation that outlawed the hiring of illegal aliens or renting to them, the battle has raged. On June 5th the federal court of appeals upheld the town's ban on hiring illegal immigrants. This has opened the door to the enactment of similar laws across the country.

Valley Park's ban on renting to illegals had earlier been struck down by a lower court, but the fight continued over hiring. A local apartment-owner who uses contractors for repair work objected to being required to verify the citizenship status of her workers. But the appeals court has now ruled that the city is not barred from imposing employment regulations that go beyond existing federal rules.

A similar case, this one from Hazelton, Pennsylvania, is still pending before another federal appeals court. Unlike Valley Park, Hazelton experienced an obvious jump in illegal aliens, who were drawn to the area by its meat-processing factories. The city cited increases in crime rates, more gang activity, higher spending on bilingual education at its public schools and on health care, and various other expenses, with no offsetting rise in tax revenues. It blamed the federal government's lax enforcement of its own immigration laws for its fiscal burden. Hazelton has led the way in the local ordinance movement and has been in one court or another most of the time since 2006.

A number of towns have already copied Hazelton and Valley Park, and so too has the state of Arizona, which has established its own citizenship-verification requirements. Voters in Fremont, Nebraska, recently passed a Hazelton-type law by ballot initiative; it is currently under review in state courts. Kris Kobach of the University of Missouri-Kansas City law school has advised Valley Park, Hazelton and a number of other cities on how they can impose their own requirements on illegal aliens while still remaining within the federal law. It looks as though his job is now going to be a lot easier.



Criminal law in California

A voice for the forsaken

Jun 11th 2009 | SAN FRANCISCO
From The Economist print edition

A law that is tough on crime can also be wantonly cruel

IN 1995, a year after Californians voted for a "three strikes and you're out" law that guaranteed much tougher sentences for criminals who reoffend, Curtis Wilkerson stole a pair of socks that cost $2.50. This is usually counted as a misdemeanour, but a prosecutor in Los Angeles got it classed as a felony. Since Mr Wilkerson had already been convicted of abetting two robberies in 1981, when he was 19, his petty theft was counted as the third strike. He was sentenced to life in prison.

Getting Mr Wilkerson and others like him out of prison is now the mission of a group of students at Stanford Law School. Under the supervision of two teachers, Michael Romano and Galit Lipa, they try to bring the most egregious injustices of California's three-strikes law before judges. About 1,000 "strikers" have written to them from prison, and about 20 are active cases. Three have been released so far.

The story of this law, the largest and toughest of its kind in the country, is a sad tale for its supporters and enemies alike. It came about after two horrendous murders of girls by people who had committed previous crimes. The killing of Polly Klaas, who was kidnapped from her home at the age of 12, shocked the state and the country. In 1994, 72% of California's voters approved the new law.

It says that criminals convicted for a second time must serve double the normal sentence, and that those with three strikes must get 25 years to life. What makes California's law so controversial is that, whereas the previous felony has to be "serious or violent", the latest crime need not be.

Hence cases such as Mr Wilkerson's. Some 25% of the 170,000 people in California's overcrowded prisons are second- or third-"strikers". And although 43% of them committed violent crimes, the rest are in for petty theft, drugs or other lesser crimes. Among Stanford's clients, one stole a dollar in loose change; another swiped some tools from a parked truck.

AP



Do they all deserve it?

Such cases have not made the law any less popular with prosecutors. They believe it does what it was meant to do, by removing the sort of monster who killed Polly Klaas from the streets and deterring others. As David Paulson, a county district attorney, puts it, the "worst of the worst" are in prison and the law "has slammed shut what was once a revolving door for career criminals." Voters seem to agree. A ballot measure in 2004 that tried to reform the three-strikes law was voted down.

The effects are not clear-cut, however. A study by the state's non-partisan Legislative Analyst's Office after the law's first decade found that crime rates in California, as in the nation, began declining before the law was passed, and that counties which used the law more had no better results than counties which used it

less. On the other hand, the law lengthens the average prison sentence and raises the average age of inmates, so costing the state an additional $500m a year. This in a state now frantically making cuts to avoid insolvency.

But the team at Stanford see individual tragedies. Their clients tend to be retarded or mentally ill and were addicted to drugs, homeless or abused as children. None has been violent, but all, says Mr Romano, have “been forsaken”, by parents, teachers, lawyers, judges and society.

Do charter schools work?

Time for a test

Jun 11th 2009 | NEWARK
From The Economist print edition

America's independent-schools movement under scrutiny

AMERICA'S universities are the best in the world, but the kindest verdict on its schools is "could do better". It spends enough on them—around the rich-world average of 3.8% of GDP—but its pupils do poorly in tests of reading, writing and mathematics, and too many drop out before completing school. Teaching attracts few ambitious and able graduates; school leaders have little autonomy. The solution, to free-marketeers, seems obvious. Give taxpayers' money not to a state-run monopoly, but to independent schools.

Since Minnesota started the experiment in 1991, most states have introduced independent, or charter, schools in some form. Evaluations have been broadly positive, but their enemies, including the politically powerful teachers' unions, can fairly claim that more research is needed. Do charter schools' pupils do better at tests because they have been coached intensively at the expense of a broad education? Do charters mean the most motivated students cluster in a few schools, to the detriment of the majority? Do they kick out—or coax out—the toughest to teach?

The answers to such questions should soon become clearer. Newark, one of America's grimmer cities, also has one of the country's highest concentrations of charter schools and is on course to have more. Seventeen schools run by 12 charter-management groups teach almost a tenth of the 48,000 children in its public-school system; by 2015 that share is likely to double. That is turning Newark into a magnet for education-policy wonks. The Newark Charter School Fund, established last year with money from, among others, the Bill and Melinda Gates Foundation, will help new schools navigate the bureaucracy, find buildings and recruit the best teachers. But it will also gather a mountain of data on the performance of every charter school, and pupil, in Newark.

All Newark's charter schools admit pupils by lottery, so tracking those who applied but didn't get in, as well as those that did, should allow comparisons between equally-motivated children of organised parents, but at different schools. If charter schools are teaching a narrow curriculum and focusing on test preparation, that should become clear when data are gathered on high-school completion rates and college destinations. If they are excluding lots of pupils, that will be obvious too. And if the state education department co-operates by giving researchers access to data on its own pupils, it will be possible to tell whether charter schools are leaching talent from state schools—or whether the challenge they pose to incumbents improves performance across the board.

Newark's charters are convinced they have a compelling story to tell. "We have never expelled a single child from one of our schools in Newark," says Ryan Hill, the director of the three schools run in the city by KIPP (the Knowledge is Power Programme), America's largest charter chain. "Great teachers prevent problems from developing in the first place." Drew Martin, a KIPP principal, is proud of his school's record in getting lagging children back on course. "More than four-fifths of our pupils are reading below grade level when they arrive aged ten," he says. "Three years later, fewer than a quarter of them still are."

Even if they are right, the debate will not be over. The final charge against schools such as those run by KIPP is that their longer hours and the demands those place on teachers (see Lexington) make them impossible to sustain, let alone replicate. Mr Hill thinks part of the solution lies in better management and training. The KIPP schools with the best teacher retention are also the oldest, he notes, suggesting that, over time, school leaders work out how to make the job manageable.

And the schools on his patch have started to train their own teachers—ensuring a ready supply of recruits. But the biggest step, he says, will be to stop children falling behind in the first place. "Our first elementary school, taking children from kindergarten up, opens in the fall, and once those children arrive in our other schools, our—and their—lives will be transformed."

New York's new casino

A break at last

Jun 11th 2009 | SOUTHAMPTON, NEW YORK
From The Economist print edition

An Indian tribe moves closer to federal recognition and to gambling



Illustration by Claudio Munoz

MOST New Yorkers are aware that Peter Minuit bought Manhattan from the local Indians for $24-worth of beads and trinkets in 1626. Some know Broadway is a former Indian trail, and that neighbourhoods, like Canarsie and Maspeth, are named for tribes long gone. Few realise, though, that there is an 800-acre (324-hectare) Indian reservation virtually on New York City's doorstep in Southampton, a town in the posh Hamptons. This beach area is where New York's rich have their summer homes. But unlike their wealthy neighbours, who come via high-end realtors, the Shinnecock Indian Nation say they are the children of a goddess who caused the land to form beneath her feet.

Even though the Shinnecocks are the oldest self-governing tribe in America and have been recognised by New York state since colonial times, they have struggled since 1978 to be federally recognised. The tribe moved a step closer on May 26th when a federal judge ruled that the Department of the Interior must make a decision by December 15th. The tribe meets the necessary criteria, so it could have federal status by mid 2010. Gordell Wright, one of the tribe's three elected trustees, observes most New Yorkers think of Indians in historical terms; but "we are here and our problems are contemporary," he says. Housing is the biggest. Because members do not individually own the land on the reservation, they are not eligible for mortgages or building loans. Often several generations of a family live in one house. Others live in trailers. Federal recognition will give the tribe access to loans from the Housing and Urban Development department.

With federal recognition will come new powers. The tribe will be able to pass and enforce laws through its own police department and court system. It will be able to collect taxes. And it will be able to enter the gambling business. The Shinnecock Nation would like to open a Class III gambling facility—one with slot machines and casino games and tables. It is unlikely its Southampton neighbours would go for a casino in their posh town, so the tribe will probably look elsewhere. The Belmont Racetrack, on the border with Queens, is one hot contender. But any site not on the reservation will need state and federal approval. Federal recognition will be a big help with that.



Lexington

The underworked American

Jun 11th 2009
From The Economist print edition

Children are exceptions to the country's work ethic

Illustration by KAL



AMERICANS like to think of themselves as martyrs to work. They delight in telling stories about their punishing hours, snatched holidays and ever-intrusive BlackBerrys. At this time of the year they marvel at the laziness of their European cousins, particularly the French. Did you know that the French take the whole of August off to recover from their 35-hour work weeks? Have you heard that they are so addicted to their holidays that they leave the sick to die and the dead to moulder?

There is an element of exaggeration in this, of course, and not just about French burial habits; studies show that Americans are less Stakhanovite than they think. Still, the average American gets only four weeks of paid leave a year compared with seven for the French and eight for the Germans. In Paris many shops simply close down for August; in Washington, where the weather is sweltering, they remain open, some for 24 hours a day.

But when it comes to the young the situation is reversed. American children have it easier than most other children in the world, including the supposedly lazy Europeans. They have one of the shortest school years anywhere, a mere 180 days compared with an average of 195 for OECD countries and more than 200 for East Asian countries. German children spend 20 more days in school than American ones, and South Koreans over a month more. Over 12 years, a 15-day deficit means American children lose out on 180 days of school, equivalent to an entire year.

American children also have one of the shortest school days, six-and-a-half hours, adding up to 32 hours a week. By contrast, the school week is 37 hours in Luxembourg, 44 in Belgium, 53 in Denmark and 60 in Sweden. On top of that, American children do only about an hour's-worth of homework a day, a figure that stuns the Japanese and Chinese.

Americans also divide up their school time oddly. They cram the school day into the morning and early afternoon, and close their schools for three months in the summer. The country that tut-tuts at Europe's mega-holidays thinks nothing of giving its children such a lazy summer. But the long summer vacation acts like a mental eraser, with the average child reportedly forgetting about a month's-worth of instruction in many subjects and almost three times that in mathematics. American academics have even invented a

term for this phenomenon, “summer learning loss”. This pedagogical understretch is exacerbating social inequalities. Poorer children frequently have no one to look after them in the long hours between the end of the school day and the end of the average working day. They are also particularly prone to learning loss. They fall behind by an average of over two months in their reading. Richer children actually improve their performance.

The understretch is also leaving American children ill-equipped to compete. They usually perform poorly in international educational tests, coming behind Asian countries that spend less on education but work their children harder. California’s state universities have to send over a third of their entering class to take remedial courses in English and maths. At least a third of successful PhD students come from abroad.

A growing number of politicians from both sides of the aisle are waking up to the problem. Barack Obama has urged school administrators to “rethink the school day”, arguing that “we can no longer afford an academic calendar designed for when America was a nation of farmers who needed their children at home ploughing the land at the end of each day.” Newt Gingrich has trumpeted a documentary arguing that Chinese and Indian children are much more academic than American ones.

These politicians have no shortage of evidence that America’s poor educational performance is weakening its economy. A recent report from McKinsey, a management consultancy, argues that the lagging performance of the country’s school pupils, particularly its poor and minority children, has wreaked more devastation on the economy than the current recession.

Learning the lesson

A growing number of schools are already doing what Mr Obama urges, and experimenting with lengthening the school day. About 1,000 of the country’s 90,000 schools have broken the shackles of the regular school day. In particular, charter schools in the Knowledge is Power Programme (KIPP) start the school day at 7.30am and end at 5pm, hold classes on some Saturdays and teach for a couple of weeks in the summer. All in all, KIPP students get about 60% more class time than their peers and routinely score better in tests.

Still, American schoolchildren are unlikely to end up working as hard as the French, let alone the South Koreans, any time soon. There are institutional reasons for this. The federal government has only a limited influence over the school system. Powerful interest groups, most notably the teachers’ unions, but also the summer-camp industry, have a vested interest in the status quo. But reformers are also up against powerful cultural forces.

One is sentimentality; the archetypical American child is Huckleberry Finn, who had little taste for formal education. Another is complacency. American parents have led grass-root protests against attempts to extend the school year into August or July, or to increase the amount of homework their little darlings have to do. They still find it hard to believe that all those Chinese students, beavering away at their books, will steal their children’s jobs. But Huckleberry Finn was published in 1884. And brain work is going the way of manual work, to whoever will provide the best value for money. The next time Americans make a joke about the Europeans and their taste for *la dolce vita*, they ought to take a look a bit closer to home.

Economist.com/blogs/lexington



Brazil's recovering economy

Ready to roll again

Jun 11th 2009 | SÃO PAULO
From The Economist print edition

Among the last to fall into recession, Brazil may be among the first to grow out of it

AFP



“NEVER before in the country’s history” is the catchphrase of President Luiz Inácio Lula da Silva that most annoys his opponents. The president, in his selective amnesia, would have voters believe that everything good about Brazil dates from his election in 2002. Even more infuriating for the previous government, which provided the precursors for progress but got no credit for it, he is often right. Take interest rates: on June 10th the central bank cut its benchmark SELIC rate to 9.25%, the first time the figure has been in single digits since the 1960s.

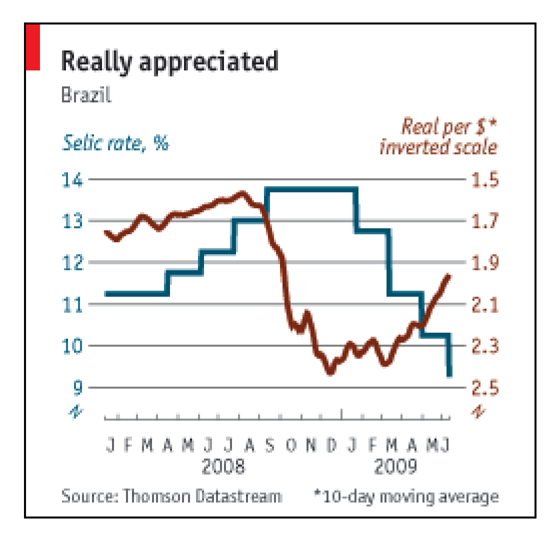
A host of measures, from the value of the stockmarket to the creation of credit, are now nearly back to their level before the collapse of Lehman Brothers in September last year. The economy performed less badly than expected in the first quarter: GDP shrank by only 0.8% compared with the last three months of 2008. Many analysts believe that Brazil is now starting to grow again, and will return to annual growth of 3.5% to 4% next year. If so, that would mean that the country has escaped with only a brief recession.

There are several reasons for this. One is that the normal business cycle is at work, as Arminio Fraga, a fund manager and former Central Bank president, points out. Brazil was overheating in the early part of last year, and the Central Bank raised interest rates. Now looser monetary and fiscal policy is speeding recovery. The financial system is sound, and domestic demand has remained robust. Brazil’s changing trade patterns have also helped to shield it. This year, for the first time, China overhauled the United States to become Brazil’s single biggest trading partner.

But familiar problems are also coming back into view. First among these, some think, is the real’s recent appreciation against the dollar (see chart). For exporters the currency is once again painfully strong, as it was before September. To ease the pressure, the powerful industrialists’ association in São Paulo wants to see some form of tax or restriction on short-term financial inflows. At the moment this looks unlikely. Left-wing economists in the governing Workers’ Party have been asking for the same thing for some time, but Lula has ignored them, preferring the Central Bank’s argument that the strong real is helping to curb inflation.

Industrialists might mind a bit less about the currency if borrowing were cheaper still. One obstacle to further cuts in interest rates,

which remain high in real terms, is the existence of a popular savings account (called *caderneta de poupança*), which offers an 8-9% guaranteed interest rate. As the Central Bank's headline rate approaches this level, the government frets about a flood of money into these accounts from investors, draining liquidity from the market for government bonds. It is mulling over whether to limit the number and size of *poupança* accounts, but tampering with this familiar product is politically difficult. Some opposition parties are stoking fears by unfairly reminding voters about a notorious bank raid by a previous president, Fernando Collor, in 1990 when the nation awoke to find much of its savings frozen.



A further bar to lower interest rates is that half of the goods that make up the main inflation measure, the IPCA, are at least partly indexed to the previous year's inflation, says Sergio Vale of MB Associados, a consultancy. This tends to dampen movement in the IPCA, and encourages the Central Bank to be cautious.

Even so, Brazil's never-before situation is leading to an uncharacteristic outbreak of long-termism. Bradesco, a large bank, has started to offer 30-year mortgages, something that would have been unthinkable a short time ago. Maílson da Nóbrega, a former finance minister, expects lower interest rates to bring a rapid expansion of mortgage finance, which at present amounts to just one percent of GDP.

Good things of this kind could still be delayed by a fresh outbreak of gloom abroad. But the debate is really about when they happen, rather than if—a testament to hard-won progress.

Waste disposal in Colombia

Muck and brass plates

Jun 11th 2009 | CALI
From The Economist print edition

Entrepreneurs, not scavengers

Still Pictures

FOR more than 20 years Carmen Lasso has scrabbled a living of sorts for herself and her eight children by scavenging at a rubbish dump in Cali, Colombia's third-largest city. Her life has brought the occasional pleasant surprise, such as the silver ring crowned with a tiny light-blue stone that she gleaned from the trash, and now wears. Another came in April when Colombia's Constitutional Court ruled that she and tens of thousands of her fellow wastepickers should be officially recognised as "entrepreneurs".

The ruling has a practical effect. The court ordered Cali's city government to suspend the tender for a waste-management concession to give co-operatives of *recicladores*, as they are known, time to organise themselves and bid for the contract. The dump they worked at was shut down last year, as part of a reorganisation of waste disposal that has already seen three contracts given to private firms.

Adriana Ruiz, the lawyer who represented the wastepickers, argued that taking away their access to garbage violated their right to livelihood and life. She also challenged a new national law under which wastepickers can be fined up to the equivalent of $500 for sorting through trash in public places. The court ruled that future waste-disposal contracts "should favour and try to preserve the status of wastepickers as self-employed entrepreneurs". The judges also suspended the fines levied by Cali's municipal government for sorting rubbish in public.

The ruling reaches far beyond Cali. In Bogotá wastepickers will rely on the ruling to bid for waste-disposal contracts to be awarded next year. The capital's wastepickers were among the first in the world to form co-operatives, and last year the city hosted the first worldwide conference of wastepickers. Ms Ruiz says that she has been contacted by wastepickers in half-a-dozen countries, ranging from Mexico and Chile to India and Mongolia, who are interested in trying to apply the same argument to gain a legally recognised stake in the waste-disposal business.

Until a decade ago, policymakers across the developing world saw informal waste collectors as a problem and worried about "how to get rid of them", says Martin Medina, who has written a book on the subject. Today, he says, they are realising that when wastepickers receive support, their co-operatives are "a perfect example of sustainable development". Brazil's labour ministry has recognised informal waste collection as a legitimate trade.

Ricaurte Larrahondo, who has worked for 42 years sorting rubbish at Cali's Navarro dump, cheered as lawyers explained the Constitutional Court's ruling to hundreds of wastepickers gathered on a hoopless basketball court in the city on June 7th. "We've always been entrepreneurs, but no one ever recognised that," he said.

Now comes the hard part. Ms Lasso, like most wastepickers, cannot read or write. To function as entrepreneurs, she and her colleagues will have to organise themselves. That in turn means overcoming longstanding feuds between street pickers and former dump pickers. In Cali they have only three months to sort themselves out before the new tender begins. It may not be enough time.

Canadians abroad

Some are on their own

Jun 11th 2009 | OTTAWA
From The Economist print edition

The judges clash with the politicians

FOR the past year Abousfian Abdelrazik, who is a citizen both of Canada and of Sudan, his country of origin, has lived in the lobby of Canada's embassy in Khartoum, unable to travel home and too frightened to venture outside. The Sudanese government, which twice imprisoned and released him without charge, wants him gone and even offered at one point to foot the bill. The Canadian government professes publicly that he is free to come home and is providing him with food and shelter. But each time he has seemed to be about to return, ministers have come up with further obstacles.

On June 4th a federal judge, drawing a parallel between Mr Abdelrazik's predicament and that of the main character in Franz Kafka's novel "The Trial", ordered Stephen Harper's Conservative government to help him return to his family in Montreal within 30 days.

It is the third time this year that a court has instructed the government to help a Canadian in trouble abroad. In each case, the court has found that the plaintiff's constitutional rights were being infringed. The government seems to have a policy of helping only those Canadians in trouble abroad whom it does not have reason to see as undesirable.

Thus it decided not to persist with an appeal for clemency nor to seek the repatriation of Ronald Smith, a convicted murderer on death row in a Montana jail. It argued that Canadians do not want murderers walking their streets. In fact, repatriated prisoners generally serve their full term in a Canadian prison. Abiding by the court ruling, it has now sought clemency for Mr Smith.

With Mr Abdelrazik and Omar Khadr, imprisoned at Guantánamo Bay since 2002, the Conservative government is following a course set by its Liberal predecessors. The decision not to help Mr Abdelrazik return to Canada was first taken by a Liberal government in 2004. Similarly, neither government requested Mr Khadr's repatriation—which a court ordered in April.

Mr Harper's people have sometimes gone to considerable lengths to aid Canadians abroad. They helped repatriate Brenda Martin, a Canadian convicted of money laundering in Mexico. They chartered ships to evacuate Canadians stranded in Lebanon when war broke out between Israel and Hizbullah in 2006.

Some Canadians, including leaders of immigrant communities, think the government should be less selective. The court decisions may achieve that result, but in a way the critics dislike.

If anything, the judges seem to have prodded the government into a firmer line. It is arguing in the court of appeal in the Khadr case that Canada has no legal duty to protect its citizens once they leave the country. The judge acknowledged that Mr Abdelrazik had associated in Canada with two people later arrested on terrorism charges. Mr Khadr is accused of killing an American soldier in Afghanistan when he was still a minor. Mr Harper may reckon enough Canadians agree with him.

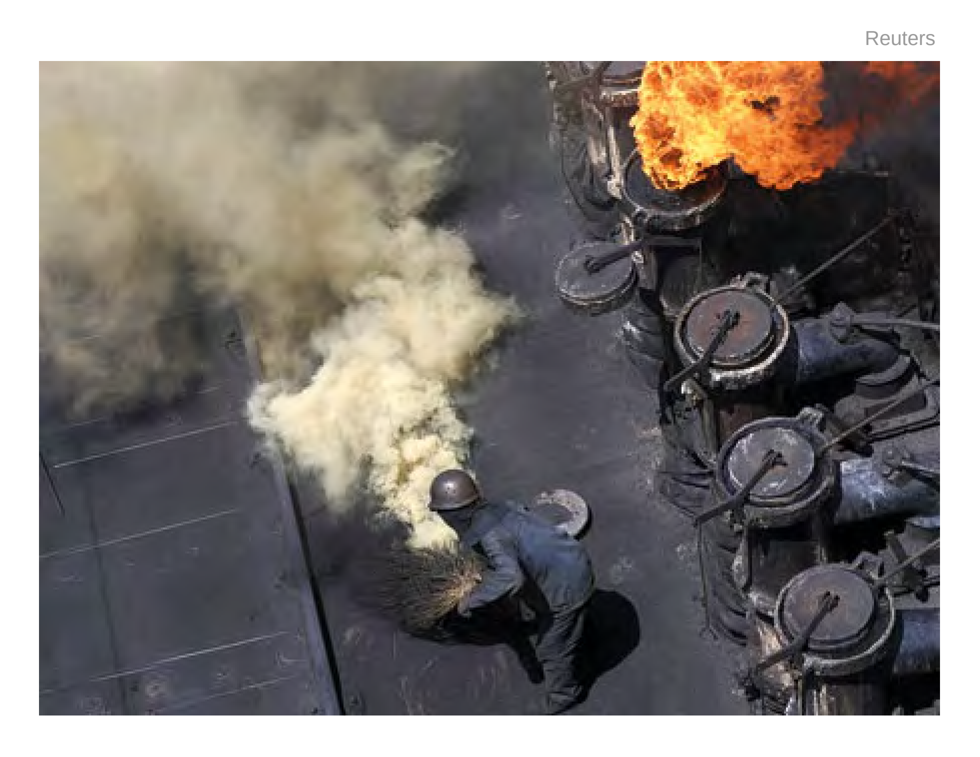
America and China talk climate change

Heating up or cooling down?

Jun 11th 2009 | BEIJING
From The Economist print edition

The big two emitters try to stop finger-pointing and save the planet

Reuters



THOUSANDS of officials from all over the world this week neared the end of two weeks of difficult talks in Bonn under the United Nations' climate convention. But they were conscious that even more difficult and probably more important negotiations were under way in Beijing. America's most senior climate-change officials were meeting their Chinese counterparts. The two countries are by far the world's biggest emitters of greenhouse gases. They will determine whether a worthwhile global treaty to limit emissions can be concluded as planned in Copenhagen in December.

The treaty is to replace the Kyoto protocol, which expires in 2012. Some 180 countries will take part in the negotiations, but many feel that, on this issue more than any other, China and America make up a "G2" that determines the global post-Kyoto agenda. Shortly before travelling to Beijing, America's climate-change envoy, Todd Stern, said that, though China may not be the "alpha and omega" of the international process, it was close. His delegation included President Barack Obama's science adviser, John Holdren, and David Sandalow, the assistant energy secretary.

Details of the talks were scanty. Mr Stern was able to call them "a step in the right direction on the road to Copenhagen". But progress is painstaking. Zha Daojiong, an energy-security expert at Peking University, says that, although he himself disagrees, many Chinese still feel the world's original big polluters should be the first to pay for cleaning things up. Others suspect American critics see the issue as yet another stick in a relentless campaign to bash China. As one American official acknowledges, climate change is emerging as the biggest issue in bilateral relations, supplanting trade and human rights.

For their part, American critics of China make much of the rapid growth in its energy consumption. Indeed, in 2007 China overtook America as the world's leading carbon emitter, with an estimated 1.8 billion tonnes of fossil-fuel emissions. As it decides how America should curb its own emissions, Congress remains keenly aware that potentially painful and costly steps will mean little if China stays on anything approaching its current trajectory.

China asserts its simple right to develop rapidly and make progress towards attaining Western living

standards. It also points out that its consumption and emission levels per head remain a mere fraction of America's. Moreover, a large chunk of its emissions come from producing goods consumed by rich developed nations, which have exported much of their manufacturing industry to China.

Lastly, China points to its impressive improvements in energy efficiency and coal-plant cleanliness in recent years, and its increasingly ambitious commitments to invest in renewable energy sources. According to Deborah Seligsohn, based in Beijing for the World Resources Institute, an American think-tank, China has received too little credit for the steps it has already taken and its commitment to do more. Others argue that China's leaders have decided both that the Obama administration is serious about climate change, and that China, especially in its drought-prone north, will be a big loser from global warming. On this analysis, they may adopt even more ambitious energy-efficiency targets, if not emissions limits.

Mr Zha urges America to refrain from browbeating China into accepting distant targets for future reductions. That, he said, would be a narrow and empty victory, since it is too late for vague visionary principles. What is needed instead, he argues, is a workable timetable under which America agrees to rethink restrictions on sophisticated exports to China, and Beijing reduces tariffs to encourage the import of cutting-edge green technology.

In this context, another development in Sino-American relations strikes a discordant note. Sichuan Tengzhong, a private Chinese company, is to buy the division of General Motors, a beleaguered American carmaker, that makes the Hummer, a gas-guzzling hulk. There could be few clearer illustrations of the shifting contours of the quarrel between rich and poor countries over who is more to blame for climate change and who should do more to arrest it. Looking more like a tank than a car, the Hummer for years seemed to embody the worst excesses of American consumerism. Now, unless Chinese regulators reject the deal, as they may, it will become another symbol of China's commercial clout and polluting potential.

Bangladesh's government

Keeping its head above water

Jun 11th 2009 | DHAKA AND GABURA
From The Economist print edition

And still popular, against the odds

HUNDREDS of thousands of people in south-western Bangladesh remain homeless after a cyclone which struck in late May, killing at least 200 people. Much of the disaster area is still under water. Some 4.8m people have been affected, and recovery will be long-drawn-out. Gabura, an island of 38,000 people surrounded by torrential tidal waters, lost 87 people dead or missing. Locals say no one can live there unless an embankment is repaired before the onset of the monsoon, due any day now. They accuse the local authorities of pocketing most of the money allocated for maintaining the embankment.

Oddly, the prime minister, Sheikh Hasina, has not yet visited the disaster area. But then, since her party, the Awami League, swept to power in an election late last year, her government has found little time for governing. Rather, it has been preoccupied with constitutional issues, and the call for trials of those accused of war-crimes in the 1971 war of secession from Pakistan. It has also been dealing with the fallout from a bloody mutiny by paramilitary border guards in February.

The report of an official investigation into the mutiny, during which at least 80 people were killed, including 57 army officers, is silent on the reasons behind it. It rules out the involvement of politicians, Islamist militants and foreign governments. But the government's response—including stepped up counter-intelligence and the immediate creation of a "National Crisis Management Committee"—shows it sees the revolt as more than a spontaneous outburst by hotheaded, underpaid soldiers.

With the Bangladesh Nationalist Party (BNP) opposition in shambles, the army is the government's biggest problem. It is still seething over the losses sustained in the mutiny. But a confrontation is unlikely. To appease the generals, the mutineers, who are not part of the army, are likely to be tried under military laws. An official inquiry will look into the death of 21 border guards, who have died in army custody. The army says they committed suicide or died of natural causes, but many Bangladeshis believe they were silenced.

So corruption—like visiting disaster victims—is low in the government's priorities. But the 20-odd members of the cabinet are seen as clean, in marked contrast to their predecessors in the government led by the BNP, toppled in a coup in January 2007. This week 12 corruption charges against Sheikh Hasina brought when she was in opposition were dropped. Her government is still very popular, despite crippling shortages of gas, electricity and water. Food prices have fallen. The press, muzzled by the BNP and the interim government that succeeded it, is much freer.

Another priority is to repair prickly relations with Bangladesh's huge, fast-growing neighbour, India. The re-election in May of a government there led by the Congress party should be good news, since Congress and the Awami League have longstanding ties. But the BNP is already accusing the government of being ready to sell out to India. And in May, two former senior intelligence officials in Bangladesh told investigators that they had facilitated gun-running by Pakistan's Inter-Services Intelligence, or ISI, to an insurgent group in India's north-east. This confirmed a frequent Indian allegation and made it probable that, at least for now, squabbles over territory and terrorism will dominate ties between the neighbours, not the prospect of increased trade and investment.

The sex industry in Cambodia

The traffic police

Jun 11th 2009 | PHNOM PENH
From The Economist print edition

'Tis a pity, but she won't go away

IN EERIE, deserted silence on the outskirts of Phnom Penh sits the Prey Speu detention centre. Barely legible on its grimy walls a few weeks ago were cries for help and whispers of despair from the tormented souls once crammed into its grimy cells. "This is to mark that I lived in terror under oppression," read one message.

It recalls a Khmer Rouge torture centre from the genocidal 1970s. But in fact the building was used just last year as a "rehabilitation" centre, where detained sex-workers, along with beggars and the homeless, learnt sewing and cooking. They were rounded up in a crackdown on trafficking for the sex industry. At first an attempt to clean up Phnom Penh, it soon escalated into a violent campaign by the police against prostitutes and those living on the street. According to Licadho, a local human-rights group, guards at the centre beat three people to death, and at least five detainees killed themselves. Sreymoa, a trafficked sex-worker, detained in May 2008 with her four-year-old daughter, recalls daily beatings, rapes and one death.

Ryan Plummer



The wrong side of the street

Partly to allay the previous American administration's concerns about trafficking, Cambodia in February 2008 outlawed prostitution. Three months later the State Department took Cambodia off its annual "watch-list" of human-trafficking countries. But the police read the law as entitling them to lock up all sex-workers, not help victims of trafficking.

Reports of abuses soon surfaced, at first denied by the government. But in August it halted the raids as the United Nations and NGOs expressed mounting concern. One worry was that they would endanger HIV/AIDS-prevention programmes. The prevalence of HIV in Cambodia had fallen to 0.8% of the population since the government adopted a campaign in 2001 for "100% condom" use. Now, however, fearing the brothels where they worked would be raided, many sex-workers had started plying their trade on the streets or in karaoke bars, where health-care workers could not find them to distribute condoms.

Tony Lisle, of the UN's AIDS organisation, says that since the raids stopped, HIV-prevention efforts have resumed with more success. Sex-workers in bars as well as brothels are to be covered, and the police to be encouraged to teach sex-workers about condom use. But those campaigning for sex-workers' rights have objected, fearing that this might give the police a pretext to renew the raids. Jason Barber of Licadho says that for years the government has stopped arbitrary detentions when a fuss has been made, only to restart them as soon as attention has shifted.

Indeed, just before a regional summit in Phnom Penh in late May, the police again herded up beggars, sex-workers and drug-users, and sent them back to Prey Speu, newly reopened (with the graffiti painted over). Detaining sex-workers is much easier than arresting the traffickers. But the global slowdown is adding to the ranks of the unemployed. The World Bank forecasts that 200,000 Cambodians will fall below the poverty line this year. Many will fall into prostitution or beggary, whatever the law says and high-minded donors hope.

Unrest in Uzbekistan

Fata Fergana

Jun 11th 2009 | TASHKENT
From The Economist print edition

Suspicions that Islamist extremists are regrouping in the valley



JUST as Uzbekistan has once again become a transit route for supplies to American and NATO forces fighting the Taliban in Afghanistan, two violent incidents have suggested the country itself may be susceptible to Islamist militants. In late May the tightly controlled official press reported a suicide-bombing in Andijan. It was said to have killed a policeman and the bomber. This followed a reported attack by militants on a border post in the city of Khanabad. Details are sketchy; there are no independent media in the country.

In the past, Islamist groups would claim such attacks, and according to a Russian news agency they did again this time. But some used to suspect that the government itself was creating an alleged Islamist threat that would justify repression. And one side-effect of America's attack on the Taliban in 2001 was the nearly complete destruction of the Islamic Movement of Uzbekistan (IMU), a small but tough group of militants whose members included citizens of several ex-Soviet republics as well as Uighurs from the restive western Muslim region of Xinjiang in China. Uzbekistan's dictator, Islam Karimov, demanded that America include IMU auxiliaries in Afghanistan among its targets, in exchange for access to bases in his country. The IMU's charismatic commander, Juma Namangani, was killed in Afghanistan in 2001 along with most of his fighters. The survivors scattered to the four winds (see article).

Now, Uzbekistan is back in focus, because of America's and NATO's need to find new supply routes into Afghanistan. The Khyber Pass from Pakistan is often closed because of militant attacks. And this year Kyrgyzstan's government has threatened to block NATO's access to its Manas airbase. Now Uzbekistan's airport in Navoi, as well as rail and road links, are to be used for the transit of what America says are non-lethal goods. This may make the country a bigger target for insurgents.

The attacks have also raised fears of increased tensions in the heavily populated, largely agricultural Fergana Valley that straddles Uzbekistan, Kyrgyzstan, and Tajikistan. Andijan, one of the valley's biggest cities, was the site of a massacre by Uzbek troops in 2005. America's calls for an independent investigation of the incident led to its eviction from the airbase in Karshi, which it had used for operations in Afghanistan from 2001.

Mr Karimov, whose regime has been in power since independence from the Soviet Union, has presided over an economy that is still largely closed and state-controlled. In agriculture, for example, the government tells farmers what crops they must grow and instructs them to sell the harvest back to the state for much less than the world market price.

Yet since last autumn many Uzbek farmers have lost land they had worked for years. Ostensibly to rationalise agricultural production, Mr Karimov decreed in October that landholdings should be consolidated. This gave local governors—the *hakims*, who often rule with an iron fist—a pretext to seize land and pass it on to cronies or those wealthy enough to offer bribes. In the past decade many farmers had signed 49-year leases, as Soviet-era collective farms were dismantled.

This land grab left many farmers landless, jobless and desperately poor. Some have gone back to work what was once their land. Yet there was already a vast surplus of workers, because of a bulge in the working-age population. Many Uzbeks have sought jobs in Kazakhstan and Russia but opportunities have been limited of

late by the global slowdown. So remittances, the lifeblood of many families and a big source of income for the country, have fallen sharply. If Islamist extremists are regrouping in the Fergana Valley, they have plenty of discontent to prey on.



The Islamic Movement of Uzbekistan

Here comes trouble

Jun 11th 2009
From The Economist print edition

The regional dimension to the insurgencies in Afghanistan and Pakistan

CENTRAL ASIA'S militant Islamists have been popping up in some unusual places. Pakistani officials say that Uzbek fighters have numbered among those captured and killed in the government's offensive to retake the Swat Valley. One Pakistani newspaper claims that local Taliban forces include up to 4,000 foreign fighters, most of them members of the Islamic Movement of Uzbekistan (IMU) who hail from the former Soviet Union. The Pakistani Taliban have not been driving just south toward Islamabad, but also northward to Malakand and Kohistan, leading some experts to fret that militants are aiming to expand their influence towards the China-Pakistan border and even farther afield to the mountains of Tajikistan, one of the IMU's old stomping grounds.



The Chinese, who have their own Islamists to worry about, are unnerved by the prospect. At the beginning of June President Hu Jintao again demanded, as Chinese leaders have done in the past, that Pakistan root out members of the "East Turkestan Islamic Movement", a reference to ethnic-Uighur separatists, once closely allied with the IMU, who have found safe haven in the tribal areas.

A few weeks ago American soldiers in Afghanistan found themselves fending off a surprisingly sophisticated ambush by well-equipped guerrillas speaking a mixture of languages on their radios, including, it is believed, Russian. American experts suspected that the attackers included Chechens and Uzbeks operating under the IMU's umbrella. For good measure, in May Russia's senior anti-narcotics official accused the IMU of trying to muscle in on the drug trade in his country. That is not quite as fanciful as it might sound. The IMU has long been suspected of profiting from the smuggling routes for Afghan opium that pass through the Central Asian republics.

The police-state methods employed by some of the governments in the region seem not to have stemmed the Islamist challenge. The harsh treatment meted out by Uzbekistan's president, Islam Karimov, to his home-grown militants—ranging from coercive beard-shaving to imprisonment in concentration camps—has failed to eradicate the IMU. But the IMU's ominous comeback illustrates a broader point as well. If the Taliban continues to wreak havoc in Pakistan, one side-effect could be the destabilisation of governments throughout Central Asia.

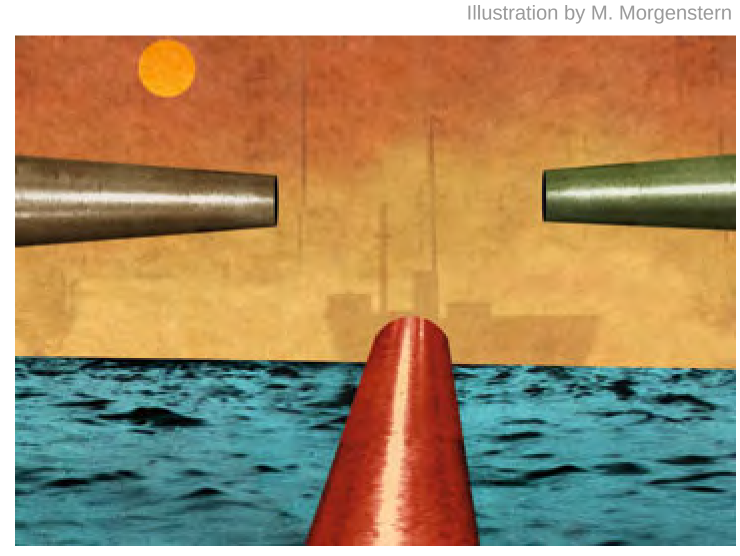
Banyan

Chasing ghosts

Jun 11th 2009
From The Economist print edition

The notion that geography is power is making an unwelcome comeback in Asia

Illustration by M. Morgenstern



A CENTURY ago the ideas of an American naval officer, Alfred Thayer Mahan—pal of Teddy Roosevelt, inventor of the term "the Middle East", advocate of American expansionism in Asia and father of the modern American navy—were much in vogue among military strategists and great-power leaders. Now they are back in fashion again, this time among Asia's rising powers.

Mahan was a founding father of geopolitics, in particular the notion that geography—poring over maps—should inform foreign policy more than any other consideration. It was the wine-dark sea that interested him most. His book, "The Influence of Sea Power Upon History", was self-fulfilling, helping sea power shape history, though not for the better. Mahan concluded that command of seaborne commerce was the key to winning wars, and that what was needed was an "overbearing power on the sea which drives the enemy's flag from it". Wilhelm, the German Kaiser, loved the book, once saying he was trying to learn it by heart. The naval arms race between Germany and Britain that followed was both catastrophic and avoidable.

The understanding of sea power has since evolved, yet Mahan is now hugely admired in Asia's two most populous powers. Banyan was recently in Singapore for the Shangri-La Dialogue, run by the International Institute for Strategic Studies, a London think-tank. It seems Britain's former naval dominance of Asia has been forgiven or forgotten (or perhaps is recalled with admiration), for this forum is where defence types now get together with old friends and future foes. And whenever Banyan prodded a military man from India or China, out leapt a Mahanite.

For China's strategic planners, securing sea lanes against hostile powers has become perhaps the chief preoccupation. For India's, it is the growth of China's presence in its backyard, in and around the Indian Ocean. In both countries Mahan is pressed into service in one planning paper after the next. James Holmes and Toshi Yoshihara of the United States Naval War College have followed the uses and abuses of Mahan. He is often selectively quoted, suppressing his equal emphasis on peaceful commerce. There is also this dictum: "Whoever controls the Indian Ocean dominates Asia. This ocean is the key to the seven seas in the 21st century. The destiny of the world will be decided in these waters." Both Chinese and Indian papers quote it. But it is a fabrication; Mahan never wrote it.

That Asia should be looking to the sea makes sense. Threats to the two biggest countries historically came from their Central Asian hinterlands. But in terms of the spread of commerce, culture, religion and empire, Asia's is a largely maritime history, carried on the monsoon winds. Asia's modern "miracle"—economies

plugged into globalised networks of supply and demand—is essentially a littoral story too, even when it falters, as now. A remarkable sight in Singapore is possibly the largest fleet ever gathered: hundreds of supertankers and bulk carriers from around the world, lying idly at anchor.

Despite the global slump, Asian growth continues. More than four-fifths of crude oil bound for China crosses the Indian Ocean before passing through the narrow Malacca Strait. Vast ship-borne imports of iron ore, coal and bauxite make up other raw ingredients for Chinese growth. India imports four-fifths of its oil, mostly from the Persian Gulf, plus liquefied natural gas from Qatar and Indonesia. Writing in *Foreign Affairs*, Robert Kaplan, an American journalist, whose poring over maps also suggests Mahanite tendencies, describes the whole Indian Ocean seaboard as “a vast web of energy trade”. Global energy needs are expected roughly to double by 2030, with India and China accounting for nearly half of the new growth in demand. Maritime security concerns are inevitable and legitimate.

The danger comes when concerns are amplified or imagined, and hitched to Mahanite prescriptions. The chief threats to peace in Asian waters come from non-state or pariah-state actors: Somali pirates, North Korean nuclear smugglers, water-borne jihadists, drug- and people-traffickers. For Chinese strategists, however, the threats are still America and India. In Singapore Robert Gates, America’s defence secretary, met his Japanese and South Korean counterparts, to reassure them in the face of North Korea’s nuclear bluster. Yet a Chinese general disapproved of the meeting and bluntly told Banyan that America’s alliances in North-East Asia were intended to threaten China.

Too much latitude

Other strategists gaze at maps and conjure up evil shapes. For Japanese imperialists (also Mahan fans), the Korean peninsula was a dagger at Japan’s heart; for Chinese strategists it is a threatening “bridgehead”. As for the Indian subcontinent, it is, in this Chinese analysis, “akin to a massive triangle reaching into the heart of the Indian Ocean” or, like Japan and Taiwan, “a giant and never-sinking aircraft-carrier”. India, in turn, espouses its own “Monroe doctrine”, demanding that outsiders keep out of its backyard. So it decries China’s “string of pearls” (roads, pipelines and ports being built in friendly countries around the Indian Ocean) as a provocation. Rivalry is helping drive a build-up of naval arms: three new aircraft-carriers for India; new destroyers, submarines and hints of an aircraft-carrier programme for China.

Mercifully, it is not all preordained to end in a rerun of 1914. The task of economic development concentrates Chinese and Indian minds at home. Smaller Asian navies are expanding as a counterbalance to the big powers, and they have an interest in keeping hands off the choke-point of the Malacca Strait. And America remains the defining force in Asia, able for now to enforce the peace. But, even if history never repeats itself, the persistence of Mahan’s doctrines suggests the past likes to have a try.

Economist.com/blogs/banyan

Crisis in Sudan

The promise and peril of independence

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From The Economist print edition

In 2011 Africa is set to get a new country. But South Sudan could well start life as a prefailed state

Panos



MAJOR JOHNSON GUCH of the Sudanese People's Liberation Army (SPLA) sits outside a grass hut at the edge of Nasir, a missionary post in Nuerland that in time became a dismal town (see map). Dressed in a tracksuit, he gives the air of a local warlord. A Nuer himself, Mr Guch is commander of a joint integrated unit (JIU) of southern and northern Sudanese soldiers mandated to keep the peace in Nasir. He says he has 150 southern soldiers, each with a small tin of bullets. But he is dismissive of the northern soldiers. He does not know how many there are. He says he does not care. It is not, in any sense of the word, a joint command.

The commander of the northern troops, Captain Osman Mustafa, is more gracious, but also more disingenuous. His tent is a walk across a black wasteland pocked by the twisted wreckage of vehicles blown up in the war and little piles of human faeces left by the locals, who eschew latrines. A Muslim from the Nuba mountains, Mr Mustafa says he has 300 soldiers, enough guns and, of course, very good relations with the southerners.

Together with a hopelessly inactive UN peacekeeping force dug in on the other side of Nasir, the JIU stood by and did nothing when one group of Nuer attacked another last month, slaughtering 71 people in the nearby village of Torkej. The Lou-Nuer targeted a cattle camp tended by women and children from the Jikany. Those sleeping outside under mosquito nets were shot point blank. The Lou sprayed the huts with bullets. They drove older children into the river, where they drowned. The Lou took the cattle and Torkej's other meagre possessions. Fifty seven wounded were taken to a Médecins Sans Frontières hospital.

The Jikany insist it is unheard of for cattle raiders to target women and children. They are furious that they had no guns to defend themselves. Under South Sudan's patchy disarmament programme,

the Jikany gave up their guns, the Lou kept theirs. Jikany elders say the Lou are working for the northern government of President Omar al-Bashir in Khartoum. They believe the north supplied at least 1,000 machineguns to the Lou in recent months. They say the Lou have been attacking their neighbours on all sides, including the Murle to the south, at the behest of Mr Bashir's government. For their part, the Lou say it is the Murle who are proxies of the northern regime.

Whatever the truth, the episode is a sign of a wider breakdown of peace across southern Sudan. In the past month or so hundreds of people have been killed in violent clashes similar to the one in Torkej, as nomadic groups compete for the best cattle and grazing land. Conflict is normal, but it is not normal for so many to be killed in this way—at least in recent years. The UN says that more people are now being killed in the south than in Darfur, Sudan's troubled western region.

Under the terms of a peace agreement with the northern government of Mr Bashir signed in 2005, the south is expected to vote for secession in a referendum in 2011. The prospect of gaining a new country, South Sudan, raised hopes of an end to Sudan's civil war between the predominantly Muslim north and the Christian and animist south, which lasted on and off for the best part of 50 years. At last, the flattened south would rebuild itself.

Now, however, even many southerners, let alone their fiercely partisan foreign backers, worry that the region's progress towards independence is going awry. Not only is there the increasing rate of intertribal violence and the hostility of the north to contend with. But the south's woes have been added to by the incompetence and corruption of the Government of Southern Sudan (GOSS), mainly composed of former guerrilla fighters in the SPLM, the political movement of the SPLA. They have managed to spend about $5 billion in oil revenues over the past four years with very little to show for it, apart from weapons. At the present rate, South Sudan will fail before it has even been born.

There is no doubt that Mr Bashir's northern government has played its part in the violence and turmoil in the south. The north has been slow to honour many of its pledges under the 2005 peace agreement with the south. In delineating the border line between the two territories, which directly effects its ownership of the country's oil reserves, the north has refused to co-operate. This has bred deep distrust between the two sides. JIUs, therefore, like the soldiers at Nasir, are "joint" in name only, and unable to keep order in the disputed border regions.

Yet it is wrong to blame the north alone. The World Food Programme says the malnutrition rate in South Sudan is 16%, which signals a permanent humanitarian emergency. Over the past four years, despite billions of dollars in revenues, the GOSS has failed to build a single paved road outside Juba, the capital. In many towns, let alone the remoter areas, the putative government of the state of South Sudan has made barely any impression at all; most new clinics or schools have been built by churches or foreign charities. Increasingly, the mess is being blamed on the south's own politicians.

The widespread perception is that the GOSS is corrupt, especially at the lower levels. The army chief was removed in a recent reshuffle after he failed to account for missing salaries. Foreign governments are reluctant to pump much-needed cash into the southern government's coffers for fear that it will be squandered.

Guns not butter (or anything else)

After the sharp fall in the price of oil last year, the GOSS suffered a collapse in its oil revenues, which make up 98% of its income. Although the government cannot be blamed for the fall in oil prices, many question why it remains so beholden to the vagaries of one commodity. Oil output is not forecast to increase in 2010 and prices, though far off their lows, may now rise only slightly.

The government needs money. The GOSS has spent over half of its income on paying its old soldiers and buying new weapons. The SPLA argues that this is an insurance against the north in case it tries to prevent secession in 2011, but the policy leaves little cash for anything else. The government has been unable to

pay salaries for months at a time and teachers recently threatened to go on strike. Some argue that the south is now bankrupt, although one person familiar with the budget process says that is an exaggeration: "It's bad, but not a disaster."

This week saw the first sign of an internal rebellion against the perceived misrule in Juba. The influential former foreign minister, Lam Akol, is founding his own party to challenge the SPLM. "Why did the SPLM fail to govern South Sudan even though it had all the money and 70% of the power?" he asked. Mr Akol will probably fight the SPLM in the national elections due next year. Given the SPLM's poor record in office so far, he may do rather well.

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South Africa's trade unions

Payback time?

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The new president runs into trouble with some of his erstwhile supporters

Reuters



Two terms? Moi?

HAVING helped catapult Jacob Zuma into the presidency, the Congress of South African Trade Unions (COSATU), the country's biggest trade union federation, is flexing its muscles. Zwelinzima Vavi, the secretary-general, has declared that the country's policies are determined not by the government alone, but by the ruling tripartite alliance, which includes COSATU along with the African National Congress (ANC) and the Communist Party. “We are the policymakers,” he said on June 4th, “and the government implements. The government doesn't lead any more.”

In normal times, this might be dismissed as so much posturing. But South Africa is suffering its first recession for 17 years, and the trade unions want to spare their members from having to bear the brunt of the downturn. The official unemployment rate has already risen to 23.5%; the real rate is much higher. And with nearly 2m members (about 11% of the workforce), most of them in the public sector, COSATU has the power to insist on being taken seriously.

It also has a just cause. Following a devastating public-sector strike, resulting in the loss of nearly 13m work days, the government agreed two years ago to replace the public sector's single salary structure with different wage scales for different jobs, including big pay rises for professions such as teachers, doctors and nurses. The agreement has never come into force.

Angry doctors, some of whom claim to be earning less than bus-drivers, have already staged wildcat strikes. Public prosecutors, police and prison officers are threatening similar action. Any further delay in introducing the new pay structures, Mr Vavi warned the government last month, could unleash “explosive spates of uncontrollable labour unrest across the country”. The two sides agreed this week to send the dispute to arbitration. But with a soaring budget deficit, the government's room for manoeuvre will be limited.

Last month COSATU almost succeeded in sabotaging the 22.5 billion rand ($2.8 billion) sale of 15% of Vodacom, a subsidiary of South Africa's state-owned telecommunications operator, Telkom, to the British-owned Vodafone. The remaining 35% was to be floated on the stock exchange. Having initially approved the deal, South Africa's independent communications regulator agreed at the last minute to join COSATU's application to the high court to stop the listing. The court overruled them.

Foreign investors remain nervous about the influence that COSATU-affiliated ministers may wield in Mr Zuma's new government. At least seven Cabinet members are former union leaders, including Kgalema Motlanthe, South Africa's former president and now deputy president; Ebrahim Patel, the minister for economic development; and Membathisi Mdladlana, the labour minister.

COSATU is now meddling in monetary policy too. Blaming the central bank's inflation targets for the recession and job cuts, it is seeking to block the reappointment of Tito Mboweni, the bank's respected governor, when his term expires in August. At the same time, it has endorsed “mass action” aimed at bringing interest rates down to what it considers “acceptable levels”. There was also surprise when Mr Vavi disclosed on June 4th that the 67-year-old president had informed COSATU that he was willing to serve for two five-year terms, instead of one, as Mr Zuma had previously declared.

But however much sympathy the populist Mr Zuma may have for trade unionists, he does not want to be beholden to COSATU. Mr Zuma always knew it would be difficult to balance the varied, and sometimes opposing, interests of those who helped him to power. From the outset, Mr Zuma insisted that he did not

“owe anybody anything.” Government appointments would be based on merit, not loyalty, he said. COSATU denounced this as “a declaration of war”.

So the ANC is hitting back against its supposed ally. Threatening strikes over wages and interest rates was “not helpful”, snapped Gwede Mantashe, the ANC’s secretary-general. It suggested that Mr Zuma’s leadership was weak and indebted to its constituencies. Furthermore, it was “none of COSATU’s business” how long Mr Zuma served as president. That was for the ANC to decide.

Tensions between the union federation and the government are running high. High enough to force Mr Zuma to deviate from his declared market-friendly macroeconomic policies? That is what everyone is now waiting to see.

Shell in Nigeria

Spilling over

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A payout could encourage others

ON JUNE 8th Royal Dutch Shell agreed to pay out $15.5m to the Ogoni people of the Niger Delta to settle a long-running court case brought against the oil giant in America by nine plaintiffs, including relatives of Ken Saro-Wiwa, an environmentalist and writer. He was executed by the brutal government of General Sani Abacha after a charade of a trial in 1995. Mr Saro-Wiwa had led a successful campaign against Shell's activities in his homeland, even forcing the company to quit Ogoniland in 1993. The plaintiffs accused Shell of complicity in the activist's death.

Shell denies any wrongdoing. It says the payout was a "humanitarian gesture"; some of the money will go to a new trust fund for the Ogoni. Shell now hopes that it might even resume oil production in the region. But things are unlikely to be that simple.

There has been a mixed reaction to the settlement in Ogoniland. Some Ogonis are disinclined to forget years of mistrust and others are in talks to clean up the oil spills that have been left untended, still oozing into farmland and rivers after 15 years. Ogoniland is just a sliver of Shell's onshore oil fields, and the out-of-court settlement is unlikely to end the company's longstanding troubles in a volatile part of Nigeria that is even more violent now than it was back in the 1990s.

The payout could also spark further court battles invoking the same American law, the Alien Tort Claims Act of 1789, originally intended to counter piracy, under which the Shell case was brought. It has been used to great effect in recent years, first against foreign officials who violated human rights, and later against firms that appeared to abet such acts. Most of the lawsuits against big companies, however, have been settled out of court, setting no clear precedents.

Pfizer, an American drugs company, is arranging details of a $75m payout to plaintiffs in the northern city of Kano. There, the Kano State and federal government of Nigeria originally claimed the equivalent of about $6 billion in damages following the 1996 trial of a meningitis vaccine that was alleged to have killed some children and left others mentally damaged. Pfizer also denies any wrongdoing. But, in a country known for its scammers and operators, the size of the payouts is likely to get people thinking.

Lebanon's election

A win for the West

Jun 11th 2009 | BEIRUT
From The Economist print edition

And the opposition, including Hizbullah, even accepted defeat graciously

Reuters



A V-sign to Iran and Syria

THE coalition that has struggled to govern Lebanon since 2005 surprised even many of its followers as it emerged from a fiercely contested general election with an undented parliamentary majority. Its win cheered the Western powers that support the grouping of Sunni Muslim, Druze and Christian parties, known as the March 14th alliance after the date of a popular uprising in 2005 against Syrian meddling in the country. The alliance is led by Saad Hariri, the son of Rafik Hariri, a murdered former prime minister.

The victory stunned its opponents, a coalition of Shia Muslim and disgruntled Christian parties, backed by Iran and Syria, that had loudly and sometimes violently disputed March 14th's legitimacy. Perhaps most surprising of all though, in a democracy-resistant region, was the opposition's humble acceptance of defeat.

Casting his ballot on June 7th, Nabih Berri, the outgoing speaker of parliament and the leader of Amal, a Shia party, had confidently declared the vote to be a referendum on the "resistance". He was referring to the powerful independent Shia militia, dominated by his ally Hizbullah, that emerged bloodied but unbeaten from war with Israel in July 2006. Mr Berri knew he could count on solid backing from Shias, who make up a third of Lebanon's 4m people and can be hostile towards a Lebanese state that has often ignored their interests.

He also believed predictions that Christians, who account for another third of the population, would mostly vote for the party headed by Michel Aoun. A former general, Mr Aoun attracts the many Christians who seek a strong leader. His supporters tend to regard the Christian parties inside March 14th as tainted by their role in Lebanon's civil war, and by their association with Druze and Sunni parties that many see as corrupt and historically hostile to Christians.

Mr Berri was right about the referendum, but wrong about the election. Although some 54% of voters backed the opposition, they did so in places where more votes produced fewer MPs. Those who voted against the resistance tended to vote in districts with proportionally more weight. Their choice reflected fears among non-Shias that the guerrilla force serves as a cat's paw for Iran and undermines the Lebanese state that protects them. Many blame Hizbullah for sparking the 2006 war, which left 1,200 Lebanese dead and thousands homeless. It is also criticised for a humiliatingly swift, though brief, takeover of Sunni parts of Beirut by Shia fighters last year.

That show of force had been prompted by March 14th's moves to curb the resistance militias, amid Western pressure to bolster the Lebanese army and police. But the Shia display of street power instead forced the March 14th alliance to accept the opposition's demands. The main one was for a veto-wielding share of cabinet seats to "protect" the resistance from state interference. Another was for a change to electoral districting, which Mr Aoun's supporters claimed had "diluted" the Christian vote in 2005, leaving his party under-represented. The fact that the opposition got these concessions and still lost helps explain why it decided to accept defeat.

Yet March 14th's capture of 71 out of 128 parliamentary seats also underlined the flaws in Lebanon's cumbersome democracy, which reserves seats for each of 16 recognised religious sects according to long-outdated census weightings, under a formula that splits parliament equally between Christians and

Muslims. Taking advantage of the imbalance between the size of the constituencies and the number of their MPs, the alliance gained a critical advantage from the massive turnout by Sunni voters in Christian districts, reflecting both demographic shifts and the financial clout of the Sunni political machine. The opposition's losses were mostly suffered by independent politicians allied to them. Hizbullah, which in the past has shied away from a deep exposure to what it calls "dirty" electoral politics, ran only 11 candidates, all of whom won handily.

The continuing divide between Sunnis and Shias echoes rivalries between outside powers that see Lebanon as an arena for their competing interests. That means that the March 14th victory is unlikely to inspire any early settlement of the feuds that have bedevilled its politics. But for the time being compromise is in the air. This is helped by the warmer winds blowing from Barack Obama's America, and the rise in Iran, engaged in an election of its own, of powerful currents arguing for accommodation with the West. If March 14th can temper its triumphalism, and Hizbullah its paranoia, Lebanon might just produce another surprise, emerging again as the model for peaceful and profitable coexistence that it was before the civil war.

Israel and America

A test of friendship

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Picking up the gauntlet thrown down by Barack Obama

Reuters



Big bad Obama wants to blow their house down

IN AN interview before his address to the Muslim world in Cairo on June 4th, President Barack Obama urged honesty in the American-Israeli dialogue. "Part of being a good friend is being honest," Mr Obama said. On June 14th it will be Binyamin Netanyahu's turn. The Israeli prime minister is due to give his reply to Mr Obama's unwelcome demands that Israel freeze settlements, accept the principle of the two-state solution and get on with negotiations with the Palestinians to bring it about.

Israeli politicians and pundits have been speculating about what the hawkish Mr Netanyahu might say. Could the name given to the speech provide any clues? At first it was dubbed "The Bar-Ilan Speech", after the university that was chosen as its venue. Was Mr Netanyahu trying by that choice to signal reassurance to his seriously worried followers on the right, among the settlers and in his own Likud party? Bar-Ilan was founded as a religious university and it retains a reputation, not entirely fairly, as a hotbed of right-wing and religious sentiment.

Then a decision was made to change the name to "The Begin-Sadat Speech", after the Begin-Sadat Centre for Strategic Studies, a think-tank attached to the university where the speech will be given. Begin-Sadat is a brace of words that evokes conflicting emotions for Israelis. The 30-year-old peace with Egypt has been a bedrock of strategic stability for both countries. But it was achieved by Israel withdrawing from all of occupied Egyptian territory—a bad precedent for the right. On the other hand, it enabled Israel to keep control of "Eretz Israel", biblical Palestine which is at the heart of the right-wing religious ideology. The peace with Egypt, moreover, gave birth to the double-talk over Israeli settlement-building in the Palestinian territories that has soured Israel's relations with America ever since. Jimmy Carter, who as president brokered the Egypt-Israel peace at Camp David, thought he had got a commitment from Israel's then prime minister, Menachem Begin, to stop building them. Begin said he had only promised to stop for three months.

Right-wingers with long memories recall, too, that Begin was able to push the Egyptian peace treaty through the Israeli parliament only with the help of the opposition Labour party. A majority of his own supporters opposed it. Is that, too, a precedent that the beleaguered Mr Netanyahu is eyeing, caught as he is between the proddings of the Obama administration and the resistance of his own coalition allies?

Today's centre-left opposition party in Israel is Kadima, led by Tzipi Livni. She lines up unreservedly behind President Obama's initiative. She says she will continue to reject Mr Netanyahu's overtures to her to join his government unless he accepts the two-state solution. If Mr Netanyahu decides on open confrontation with the American president, the tenor of Israeli politics could rapidly turn ugly. Ms Livni could find her party's patriotism impugned by the more strident voices on the right. Some of these have already accused Mr

Obama of seeking to engineer regime change in Israel.

Keeping up the pressure between the two speeches, Mr Obama's peace envoy, George Mitchell, visited Jerusalem and Ramallah this week. Calling on Israel's president, Shimon Peres, he said pointedly that America wanted "the prompt resumption and early conclusion" of negotiations on a two-state solution. He then spent several hours closeted with Mr Netanyahu.

Mr Peres, perennial peacemaker, said Mr Obama's speech had left "a feeling of elation" in the region. But has any of it rubbed off on Mr Netanyahu?

The European elections

Swing low, swing right

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From The Economist print edition

A low turnout, a shift to the centre-right and seats for the far right and a few loonies. We report from across Europe, starting with an overview

Illustration by Peter Schrank



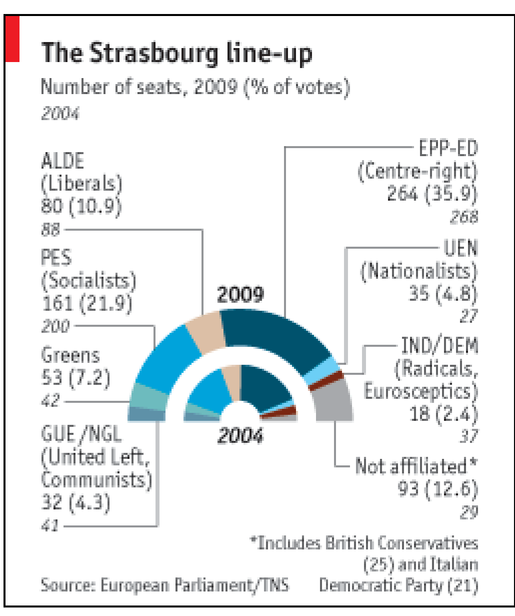
CONSERVATIVE, fretful about immigration and in no mood to tolerate scandals among the ruling classes. That is the snapshot of European voters captured by elections to the European Parliament that ended on June 7th after four days of voting in 27 countries. European campaigns are usually dominated by local and national concerns, making them hard to read. But this time there was no mistaking some broad trends. The centre-left failed to capitalise on an economic crisis tailor-made for critics of the free market. Support for mainstream centre-right parties held steady or fell slightly. Incumbents were not uniformly punished, but those caught in scandals involving power, privilege and perks were. And a chunky protest vote went to populist and far-right outfits vowing to close borders, expel immigrants or dismantle the European Union.

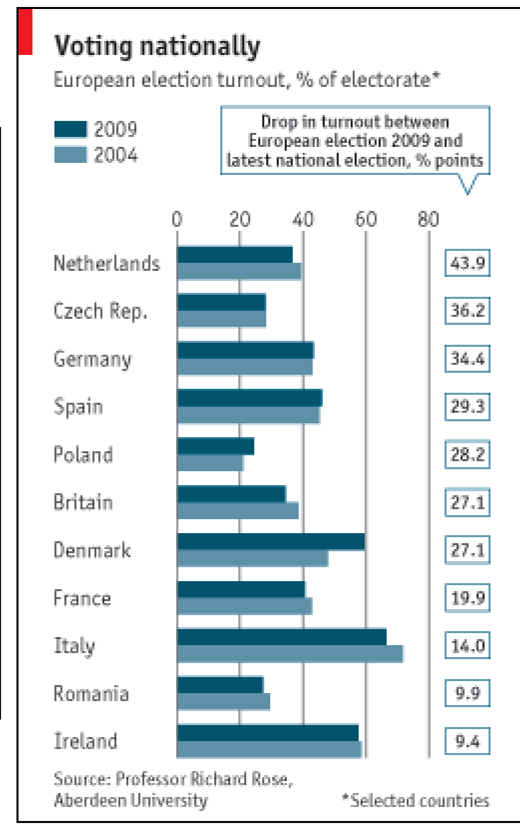
Average turnout dropped two points, to 43%, the lowest since 1979. But that conceals wide variations. In Scandinavian countries and Estonia turnout rose sharply. In most populous countries it fell or stayed low. Everywhere it was below levels in recent national elections, notes Richard Rose of Aberdeen University (see chart).

Britain's grumpy relations with the EU were left more ambiguous than ever. Voters angered by the recession and the parliamentary-expenses scandal deserted the Labour Party, giving it just 16% of the vote. That pushed Labour into third place, behind a Conservative Party campaigning to return powers from Brussels and the United Kingdom Independence Party, which wants to leave the EU. The Conservative leader, David Cameron, has pledged to take his 25 members of the European Parliament (MEPs) out of the centre-right European People's Party (EPP) into a new anti-federalist group with allies drawn from footloose parties around Europe. The Tories have the numbers (the threshold is 25 MEPs) but they need members from at least seven countries. Mr Cameron has signed up the Czech Civic Democrats and Law and Justice from Poland. But finding others who

share his Euroscepticism yet believe in free trade and do not exude a sulphurous whiff of extremism may be tricky.

The new parliament will have plenty of what Professor Rose calls “drawbridge parties” that want to defend national boundaries against alien influences, including Brussels. In the Netherlands the Party of Freedom, led by Geert Wilders, vows to ban the Koran, scrap the parliament and kick out Romania and Bulgaria. In Finland the anti-immigrant “True Finns” party came from nowhere to win a seat. In Hungary three seats went to the xenophobic Jobbik, which has a “civil defence” militia, the Hungarian Guard. Far-right, anti-immigrant parties gained seats in Austria, Denmark, Greece, Italy and Slovakia. The British National Party took two seats. The far left picked up a seat in Denmark, but did not break through in France and Germany.





Recession has “not automatically punished incumbents”. In France Nicolas Sarkozy’s ruling UMP came first with 28% of the vote. A fractious and squabbling French Socialist Party only just escaped being pushed into third place by an alliance of ecologists and Green-tinged anti-capitalists. The Greens held on to third place in Germany, but at EU level the movement remains limited by its internal incoherence: some Euro-Greens are quasi-liberals, others are allied with the extreme left.

Germany’s Social Democratic Party (SPD) had its worst result since the war, winning less than 21% of the vote. The SPD suffers from being locked in a grand coalition with Angela Merkel’s Christian Democrats. Ms Merkel easily held on to first place, though her support was down from 2004. The ruling Socialists in Portugal saw their vote fall sharply, allowing the centre-right to claim victory. In Spain the Socialist government also lost to a conservative opposition, but by a smaller margin. In Poland the left was crushed, with 75% of the vote going to the centre and right.

In Italy Silvio Berlusconi’s conservative Party of Freedom came out top. But Mr Berlusconi’s vote fell short of the 45% he had predicted, following a media furore over his private life. A string of financial scandals also helped to undo the ruling conservative government in Greece, allowing the socialist opposition of PASOK to buck the trend and come first.

European Parliament seats, by country and political group*

	EPP-ED (Centre-right)	PES (Socialists)	ALDE (Liberals)	Greens	UEN (Nationalists)	GUE/NGL (United Left, Communists)	IND/DEM (radicals, Eurosceptics)	Not affiliated	TOTAL SEATS
Germany	42	23	12	14	–	8	–	–	**99**
France	29	14	6	14	–	4	1	4	**72**
Italy	35	–	7	–	9	–	–	21[†]	**72**
Britain	–	13	11	5	–	1	13	29[‡]	**72**
Spain	23	21	2	2	–	1	–	1	**50**
Poland	28	7	–	–	15	–	–	–	**50**
Romania	13	11	5	1	–	–	–	3	**33**
Netherlands	5	3	6	3	–	2	2	4	**25**
Belgium	6	5	5	3	–	–	–	3	**22**
Czech Rep.	2	7	–	–	–	4	–	9	**22**
Greece	8	8	–	1	–	3	2	–	**22**
Hungary	15	4	–	–	–	–	–	3	**22**
Portugal	10	7	–	–	–	5	–	–	**22**
Sweden	5	5	4	2	–	1	–	1	**18**
Bulgaria	6	4	5	–	–	–	–	2	**17**
Austria	6	4	–	2	–	–	–	5	**17**
Denmark	1	4	3	2	2	1	–	–	**13**
Slovakia	6	5	–	–	1	–	–	1	**13**
Finland	4	2	4	2	–	–	–	1	**13**
Ireland	4	3	1	–	3	–	–	1	**12**
Lithuania	4	3	2	–	2	–	–	1	**12**
Latvia	1	–	1	1	3	–	–	2	**8**
Slovenia	3	2	2	–	–	–	–	–	**7**
Estonia	1	1	3	–	–	–	–	1	**6**
Cyprus	2	1	–	–	–	2	–	1	**6**
Luxembourg	3	1	1	1	–	–	–	–	**6**
Malta	2	3	–	–	–	–	–	–	**5**
Total EU	**264**	**161**	**80**	**53**	**35**	**32**	**18**	**93**	**736**

Source: European Parliament/TNS *Provisional. National parties can switch allegiances †Italian Democratic Party ‡25 Conservatives

Ireland has only 12 seats in the European Parliament, but its results were watched closely because in October the Irish are likely to vote again on the Lisbon treaty after rejecting it a year ago. There was relief in Brussels when pro-Lisbon candidates took 11 seats. And there was glee at the defeat of a millionaire businessman, Declan Ganley, a big backer of the No campaign. He founded a new party, Libertas, for the elections, and hundreds of Libertas-affiliated candidates stood across Europe. Mr Ganley predicted that more than 100 would win. In the event, Libertas secured just one MEP, a French nationalist, Philippe de Villiers. Mr Ganley is standing down from politics and will not now campaign in the second Lisbon referendum; he said pointedly that he was a democrat who could “take no for an answer”.

Overall the Socialists, though still the second-largest group, are much diminished. In the past all three big groups—the centre-right, centre-left and centrist liberals—have had to reach a consensus on most legislation. The rout of the centre-left has led some MEPs to predict that a new “centre-right” majority may now control voting more often. Old consensual habits die hard, though. Faced with more Eurosceptics, the EPP chairman, Wilfried Martens, told reporters that the three political “families that created Europe” were still bound to work together.

The centre-right’s strength makes it likely that MEPs will approve a second term for the European Commission’s president, José Manuel Barroso, after his nomination by the EU’s 27 national governments. When this will happen is less clear. Some countries (and Mr Barroso) want a binding deal at next week’s EU summit. France is arguing for delay, ostensibly to wait for the Lisbon treaty, though in fact in an effort to secure a big economic portfolio for the next French commissioner. But the Swedish prime minister, Fredrik Reinfeldt, who takes over the rotating EU presidency on July 1st, said bluntly on June 9th that he wanted no further delay.



WORLD
EUROPE

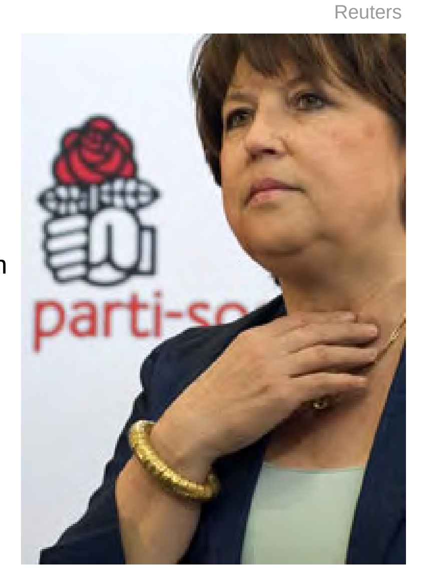
France's victorious centre-right

Sarkozy on top

Jun 11th 2009 | PARIS
From The Economist print edition

A good result for the centre-right, a bad one for the main opposition parties

Reuters



Aubry gets it in the neck

EUROPEAN elections carry a haunting memory for Nicolas Sarkozy. Ten years ago, as head of the Gaullist list, he was battered into third place. That defeat marked the start of a little-known three-year political exile for the aspirant leader. So this week's result was especially pleasing for the president. His UMP party came top, the first time since 1979 a sitting president has done this with 28% of the vote. The Socialist Party scraped a miserable 16.5%.

Mr Sarkozy's success was impressive given the recession, the tendency of French voters to punish incumbents and his own unpopularity. In May the president's approval rating dropped to 32%, according to TNS Sofres. Yet Mr Sarkozy not only saw off the far-right National Front, thanks to tough anti-crime talk and a promise to oppose Turkish entry into the European Union, but also drove home his slogan, "When Europe wants to, Europe can", talking up the hyperactive French presidency of the EU in the second half of 2008. His score mirrors the 31% he took in the first round of the 2007 presidential election, suggesting that his base is solid.

Mr Sarkozy has also divided and weakened the opposition. He has pinched the left's rhetoric, denouncing "financial capitalism" and calling for a "Europe that protects". He has grabbed its talent, putting many left-wingers into government. Voters were left to shop around for a credible alternative to the lamentable Socialist Party, which only just avoided losing to the Greens, who took 16.3%. Even the Socialist spokesman, Benoît Hamon, lost his seat. In all but one of the 20 *arrondissements* of Paris, a city with a Socialist mayor, the party was trampled into third place.

The Socialists were not the only opposition party to suffer. François Bayrou, a centrist, bagged just 8.4%, ten points less than in the first round of the 2007 presidential poll. His ferocious *anti-Sarkozysme* backfired, casting him as a bitter, obsessive figure. Olivier Besancenot's New Anti-Capitalist Party secured under 5%. The only opposition winner was Europe Ecologie, a group of green activists, film-makers, anti-globalisation campaigners (José Bové) and one-time revolutionaries. It is led by Daniel Cohn-Bendit, a Franco-German figure from May 1968 who is now more a bourgeois eco-romantic than a hardened rebel, and Eva Joly, a Franco-Swedish retired magistrate. This unlikely pair of 60-somethings drew those disaffected from the mainstream but repelled by extremism.

The outlook for the Socialists is dismal. Martine Aubry, who was elected party leader six months ago, admitted that her party had "not been credible". Younger aspirant leaders mutter about the need for an "electric shock". There is talk of reaching out to the Greens. But even her critics concede that there is no unifying rival capable of imposing authority, a fresh image or new thinking. Ségolène Royal, the party's defeated presidential candidate, is distrusted by many. After a leadership meeting this week, Ms Aubry is likely to stay in the job. The Socialists may be condemned to another period of futile introspection.

Mr Sarkozy's authority has increased. He will reshuffle some ministers, partly because two—Rachida Dati at justice and Michel Barnier at agriculture—are off to the European Parliament. But the prime minister, François Fillon, will stay, along with Christine Lagarde at finance and Bernard Kouchner, the foreign minister. Mr Sarkozy may further embrace greenery. He may not be popular, but this result validates his central strategy: mobilise your friends and divide your enemies.

The Eurosceptic Dutch

Wilders rides in

Jun 11th 2009 | THE HAGUE
From The Economist print edition

Success for the far-right enfant terrible of the Netherlands

IT WAS no surprise that the far-right Freedom Party did well. But even its leader, Geert Wilders, did not expect to come second. Yet a combination of strong Euroscepticism and strident anti-Islamic rhetoric won 17% of the vote for Mr Wilders, giving his party four seats in the European Parliament—one fewer than the Christian Democrats. Eurosceptic parties, which include the far-left Socialists and a pair of small Calvinist parties, took nearly a third of Dutch seats.

Mr Wilders campaigned on simple messages: a bigger European Union budget rebate; less interference from Brussels, especially on immigration policies; and blunt rejection of Turkey's joining the EU. His party promises to make sure that this "undiluted voice" is heard in Brussels. That may be hard, not least because the Freedom Party plans not to join any parliamentary group, leaving it little speaking time and few staff. But Mr Wilders is confident of his impact. "We still have the whole media circus to play," he said on television.

His success reflects the qualms that in 2002 led many Dutch voters to back Pim Fortuyn (before he was murdered); and in June 2005 inspired a majority to reject the draft EU constitution. These include hostility to immigration and Islam, and broad fears about loss of sovereignty and national identity. It is compounded by a lack of trust in the establishment. "People don't believe any more that the Dutch or the EU establishment are able to protect them," says Bas Heijne, a political observer. The parties that fared worst are from the establishment: the CDA, the liberal VVD and the Dutch Labour party. Labour lost so heavily that Mr Wilders questioned if it could decently stay in the coalition government.

The mainstream has good reason to worry. Mr Wilders's vote would translate into 24 seats in the national parliament, making him hard to avoid as a coalition partner. He is calling for an early election. But his success may stabilise the government in the short run, since other parties do not want to face voters yet. Many hope that Mr Wilders, like earlier populists, will trip up before the election, due by May 2011. But Mr Wilders has proved more astute than his predecessors. And the people to whom his ideas appeal are in the Netherlands to stay—and vote.

But still it moves

Jun 11th 2009 | ROME
From The Economist print edition

The right wins, but less than expected as the Northern League does well

TO MOST Europeans, the result in Italy must have seemed bewildering. For a month Silvio Berlusconi has been enmeshed in a sex scandal that might have forced any other leader from office. The day before the vote, it became spicier. *El País*, a Spanish newspaper, published photographs impounded in Italy showing unidentified topless beauties by the pool at Mr Berlusconi's Sardinian villa and a naked Mirek Topolanek, a former Czech prime minister. Yet Mr Berlusconi's People of Freedom (PdL) still emerged with 35.3% of the vote, nine points ahead of the opposition Democratic Party (PD).

"After the attacks he has suffered, no [other] politician in the world would have achieved this result," declared Ignazio La Russa, a PdL official. Yet most Italian commentators judged the outcome a defeat for Mr Berlusconi. The PdL's share of the vote on its first outing as a unified party was two points lower than at the 2008 general election, when it was mainly an electoral alliance. And it fell short of expectations. Mr Berlusconi had claimed overwhelming personal support—over 70%, he said. He gave a troubling impression that his popularity justified limiting the checks and balances typical of a democracy. The result brought him back to earth, reminding him that Italians vote PdL for more complex reasons than blind love of its leader.

His party's tally fell well short of his associates' target of 40%, let alone Mr Berlusconi's own aspiration of 45%. The prime minister put himself top of the candidate list and was reportedly expecting 3m-4m preference votes. That he received 2.7m was a personal setback, as was the fact that the PdL did better in local elections held at the same time. Where did its votes go? Certainly not to the PD, which missed its own 27% target. The stridently anti-Berlusconi Italy of Principles party, on the other hand, doubled its share, to 8%.

In the south Mr Berlusconi's party suffered from abstentions. Elsewhere the PdL lost votes to its coalition ally, the Northern League, which is emerging as the party of Italy's rednecks. It won over 10% of the vote and may now hold greater sway over the government. On June 9th Mr Berlusconi gave the league a concession by dropping an electoral reform that would have made it harder for the league to hold future governments to ransom.

Did the outcome show that the electorate cares about politicians' private lives? Up to a point. But the fact that the PdL suffered from abstention in the traditionally macho south implies that much of the discontent was caused by recession. Mr Berlusconi has so far spent most of his energy on two issues: law and order and institutional reform. It is high time he switched his attention to the economy.

Germany looks to September

Merkel's mood music

Jun 11th 2009 | BERLIN
From The Economist print edition

Angela Merkel should stay chancellor, but the coalition could change

“THE launch pad is not as good as we had imagined,” said Peer Steinbrück, the finance minister. That is an understatement. Mr Steinbrück’s Social Democratic Party (SPD) won just 20.8% of the vote in the European election, its worst performance in a countrywide contest since the war. Victory in the federal election on September 27th is improbable. So the SPD’s Frank-Walter Steinmeier, foreign minister in the grand coalition, is unlikely to replace Angela Merkel, leader of the Christian Democratic Union (CDU), as chancellor.

The CDU’s share of the vote fell from 36.5% in 2004 to 30.7%. It did badly in local elections on June 7th. But it is still the largest party. Its sister party, the Christian Social Union (CSU), traumatised in September when it lost its absolute majority in Bavaria for the first time in 46 years, feared it might be out of the European Parliament, but easily cleared the 5% threshold. And the liberal Free Democratic Party (FDP) doubled its share of the vote, to 11%. If these results were repeated in September Ms Merkel could dump the SPD for a “bourgeois” coalition with the CSU and FDP.

Yet she cannot count on that. A turnout of only 43%, close to a record low, suggests that only the most intrepid voted. These include older voters, who lean to the CDU, and prosperous do-gooders who back the Green Party, which came third, with 12% of the vote. Turnout in September may be 30 points higher, bringing back traditional supporters of the SPD (and of the ex-communist Left Party). In a parliament with five parties (counting the CDU and CSU as one) the only pair that can be sure of a majority is a grand coalition.

The SPD has built its campaign around Mr Steinmeier, a competent but colourless ex-bureaucrat who has never run for any office, and on the notion that it can cope best with the economic crisis. It claims credit for the government’s stimulus package and for bail-outs of big employers such as Opel. It paints the CDU as a reluctant partner in such rescue operations; if allowed to govern with the liberals, it says, the CDU will reveal its true heartlessness. The CSU’s aristocratic economy minister, who resists corporate bail-outs, is the “baron from Bavaria” in SPD-speak. With similar tactics, the SPD came surprisingly close to defeating the CDU in 2005.

Yet this time they do not seem to be working. More than half the voters want Ms Merkel to remain chancellor; only a quarter favour Mr Steinmeier. The SPD is being punished for pursuing “no consistent political course,” says Matthias Jung of Forschungsgruppe Wahlen, a pollster. Voters remember the Agenda 2010 labour-market reforms by the previous SPD-led government as the height of heartlessness, so its recent turn towards tenderness does not convince them. The European defeat has reignited a debate over whether the party has turned too far left or not far enough. Ms Merkel has not been much more consistent, bowing repeatedly to SPD demands for more “social” policies. But voters seem to trust her to know where to draw the line: she said yes to the Opel bail-out, but no to Arcandor, which filed for bankruptcy on June 9th (see article).

The Germans shunned Eurosceptics and the far right. In crisis they like parties offering economic competence, not utopias. That may change with rising unemployment. But voters are now deliberating between the status quo and a new constellation even friendlier to capitalism.

Spain's People's Party wins

Rajoy ahoy

Jun 11th 2009 | MADRID
From The Economist print edition

A small fillip for the opposition

AFP


Rajoy wins one, at last

IT TAKES more than an economic crisis to revolutionise Spanish politics. Bombs, like those that killed 191 people on Madrid trains in 2004, can topple governments. But unemployment at 18% does not. So the European elections, which gave the opposition People's Party (PP) a modest four-point victory, suggest. Yet the PP's win was significant. This is the first national vote it has won over José Luis Rodríguez Zapatero's Socialists in nine years. "A majority have expressed their will for change," said the PP leader, Mariano Rajoy.

Has the tide turned? There are plenty of ills to worry about. One in five Spaniards will soon be out of work. Economists predict that Spain will be one of the last rich countries to emerge from the recession. Some 30% of children leave school without qualifications. Only 5% of exports are high-tech, and research spending is feeble. More than a million new homes sit unsold. Meanwhile a large part of the workforce is protected by armour-clad contracts.

Yet the PP's modest win does not mean that all Spaniards want change. It will help Mr Rajoy to see off both critics and potential challengers. It will also boost the PP's confidence as it tries to trip Mr Zapatero up in parliament, where he is seven seats short of a majority. What it will not do is put Mr Zapatero's back against the wall. Indeed, with a general election still three years off, he may have time to see the recession through. Even the glummest economists do not see it lasting until 2012.

Spain takes over the six-month rotating European Union presidency in January, offering Mr Zapatero photo opportunities galore with world leaders. His party machine is already trying to sell him as "Europe's Obama". He has serious business to attend to at home—which an absence of elections should make easier. First is the parlous state of some savings banks. Spanish banks may have avoided subprime excesses, but home-made poisons are floating to the surface. The Caja Castilla La Mancha was only the first to fall; more may soon be in trouble and a €9 billion ($13 billion) rescue fund is in the pipeline.

A longer-term task is to transform Spain's low-tech economy. Mr Zapatero promises a sustainable-economy law but has given few details. He has no desire to confront the unions, so radical labour-market reform is unlikely. Real change might require him to make enemies. He has shown no appetite for that.

Scary elections in eastern Europe

Time to start fretting

Jun 11th 2009
From The Economist print edition

Boring centre-right parties did well—but so did quite a few nasties

INTEPRETERS in the European Parliament trying to translate the remarks of George "Gigi" Becali may struggle. Even in his native Romanian, his puzzling syntax and coarse slang make him a butt of satirists. The interpreters may also blench at what he says, especially about Jews, gays, Roma (Gypsies) and women. But they may be spared this for the time being because a court has banned the newly elected Mr Becali from leaving Romania pending a criminal trial for kidnapping.

Xenophobes and populists have been elected in old European Union members such as the Netherlands too. But their east European counterparts make the westerners seem tame. Mr Becali's fellow victor on the Greater Romania list is Corneliu Vadim Tudor, a vituperative nationalist who was once court poet to Nicolae Ceausescu, the former Communist dictator.

Getty Images



Nutters? Us?

Yet international co-operation among politicians who hate foreigners is inherently tricky. Hungary's far-right Jobbik party, which won three seats, may join its Balkan counterparts (including two members of Bulgaria's explicitly racist Ataka party) in Roma-bashing. But they will have little in common when it comes to minority rights for Hungarians in neighbouring countries such as Slovakia and Romania, where Magyar irredentism is a convenient bogeyman for local chauvinists.

There were shocks at the far-left end of the spectrum too. One winner in Latvia was Alfreds Rubiks, a hardline former Communist who was jailed for backing a Kremlin-inspired coup against Latvian independence in 1991. Most Latvians see him as a pariah. His victory highlights the ominous rise of Soviet nostalgia among the country's increasingly alienated Russians. In Estonia, by contrast, ethnic Russian parties flopped. The soft-left Centre Party got their votes, and more besides. The most striking Estonian result was the election of Indrek Tarand, a popular ex-diplomat who ran as an independent to protest against rules stopping voters from choosing among candidates on party lists.

As in western Europe, the main stories in the east were thumping wins by centre-right parties. Poland's ruling Civic Platform did strikingly well, with 25 seats to 15 for the main opposition, the more populist Law and Justice party. In the Czech Republic the centre-right Civic Democrats won nine of the 22 seats, against seven for the Social Democrats and four for the Communists. In Hungary the ruling Socialists (ex-communists) did very badly, with only four seats to 14 for the conservative Fidesz party. That augurs well for the right in next year's general election.

The exception was Slovakia, where the ruling centre-left Smer (Direction) party led by the prime minister, Robert Fico, did well on a paltry 19.6 % turnout, the lowest in the EU. His party won five out of 13 seats, with the fragmented conservative opposition polling poorly, as did two nationalist fringe parties in the coalition government. Both had featured in a string of recent corruption scandals.

The real significance of the elections may lie less in the composition of the new European Parliament than in pointers to the future course of national politics. Mr Fico, for example, will need to find new allies after next year's general election if his present coalition partners continue to flop. Poland's Civic Platform is on track to win the presidency next year.

Scandal-strewn Bulgaria is holding a parliamentary election on July 5th. If the European contest is any guide, the vote should be lively but nasty. Mafia-linked parties did alarmingly well in the European poll,

though they did not win any seats. Vote-buying was common, as were other lurches towards rule-bending and ballot-rigging. In what looks like a blatant attempt to penalise minor parties, the authorities tried (but failed) to raise the election threshold to 8%, the highest in Europe. Legal chicanery meant that an opposition coalition had great difficulty even registering. Sadly, EU officials monitoring Bulgaria's shaky progress towards clean government will have plenty to put in their next report. It is bad enough when dodgy characters win votes, but even worse when they count them.

Latvia's economic woes

Lat in the lurch

Jun 11th 2009 | RIGA
From The Economist print edition

Vultures are circling over Latvia

LIKE many small countries, Latvia has struggled to attract outsiders' attention. Now it is famous, and hating it. The economic contraction—GDP down nearly a fifth, imports and exports down by more than 40%—is on a scale rarely seen in peacetime. Life support for the economy is being given by outsiders. Foreign banks are nervous (see article). Much depends on parliament accepting more big budget cuts: nearly $1 billion this year and the same next year. The package includes ditching the flat tax on incomes. The government agreed to this new budget, belatedly, on June 8th.

That should unlock the next $1.67 billion tranche of aid from the European Union and the IMF, part of a $10.6 billion deal from late last year. But is it throwing good money after bad? Some bits of good news suggest that the economic collapse may have halted. Latvia's flexible economy means it may manage painful reforms that amount to an "internal devaluation". That could regain lost competitiveness and restore growth.

Others think that Latvia must sacrifice the peg to the euro that has been the centrepiece of economic policy. The Bank of Latvia has spent over a tenth of its reserves in the past fortnight propping up the lat. Interest rates have spiked, and a government debt auction failed last week. Sweden's central bank is borrowing €3 billion ($4.2 billion) from the European Central Bank, in case it needs to shore up Swedish banks that lent in Latvia. Past crises in Latin America and East Asia echo ominously. Bengt Dennis, a Swedish adviser to Latvia's government, says devaluation is inevitable.

But the lat's guardian, the Bank of Latvia's governor, Ilmars Rimsevics, is unshaken, pointing to the "beauty" of the currency-peg system. All lats in circulation are backed by euros. If people want to switch, they can, but as interest rates rise, holding lats becomes more attractive, he argues. The central bank's independence from government is legally impregnable.

Joaquín Almunia, the EU's monetary affairs commissioner, backed the peg this week. But political weakness still overshadows Latvia's chances. The steely (critics say arrogant) Mr Rimsevics is barely on speaking terms with the prime minister. Latvia's real deficit is not in the public finances but in the state's credibility, squandered in the past by spendthrift and sleazy politicians.

Charlemagne

The endless election round

Jun 11th 2009
From The Economist print edition

Why do members of the European Parliament never learn from experience?

Illustration by Peter Schrank



AT ONE point on his travels Captain Lemuel Gulliver visits an academy filled with mad scientists. Their experiments are all odd. But what makes them mad is that they are repeated, again and again, whenever they fail. One scientist has spent eight years attempting to extract sunbeams from cucumbers. Vowing to succeed in another eight years, he asks Gulliver for a donation, it being “a very dear Season for Cucumbers”.

Jonathan Swift, the author of this satire, would have felt at home in Brussels on June 7th, as the results of the European elections in 27 countries trickled in. The parliament has spent much time and money this year trying to reverse a 30-year trend of falling turnout at Euro-elections. Jolly posters were stuck up across the European Union. The parliament started its own Twitter feed, and put short films up on YouTube depicting the larky side of voting for Europe. One showed bank robbers stopping to cast ballots, mid-heist, under the slogan: “There’s always time to vote”.

It made no difference: average turnout was 43%, slightly down on 2004. Moments after the polls closed, members of the European Parliament (MEPs) fanned out across Brussels to explain to reporters why this was not their fault. The parliament does a terrifically important job, went one argument: alas, too few voters know this. Many MEPs accused national governments of taking credit for EU successes, while blaming Brussels for anything unpopular. The big problem is the media, others said: national television stations and newspapers do not spend enough time reporting on MEPs’ work. What is needed is more pan-European news coverage (maybe subsidised by the EU).

In fairness, some excuses offered by MEPs for low turnout are persuasive, though they are not so good at explaining why it keeps falling. National governments do use Brussels as a scapegoat. Press coverage of the parliament is skimpy, partly because much EU work is important but dull. Finally, MEPs point to other elections that do not lead to a change of government, from local elections in Europe to congressional mid-terms in America, and note that their turnouts are equally dismal.

All of these excuses for failure are reasonable. But like the scientists of Swift’s Grand Academy of Lagado, MEPs seem unable to take the next logical step and ask why they are left to explain failure every time they hold an election. Over the years the European Parliament has proved skilled at acquiring new legislative powers, arguing that it is the body that connects voters democratically with the EU. But that is not a proven

fact; it is an experimental proposition. And when it is tested every five years, the evidence to support it seems decidedly weak.

Yet the response from MEPs is unvarying: more of the same. Graham Watson, leader of the parliament's liberal group, says that the EU has succeeded in creating a "European democracy". He concedes that it has failed to create a "European demos". His answer is to give Euronews, an EU-funded television outfit, the resources and status of a public-service broadcaster in each country. He wants EU commissioners chosen from among MEPs. His group also plans to propose that a fifth of all MEPs be elected by Europe-wide electoral districts, to "get away from this awful tendency to have 27 different national campaigns".

When to stop trying

But here is another thought: what if pan-European politics is an experimental cul-de-sac? Take Europe's socialist parties, which made much noise about running on a single, pan-European manifesto. It did not do them much good, as the centre-left fared badly. And one obvious problem was incoherence, since European socialists are riven by divisions over globalisation. In places like France the talk is of Europe-wide minimum wages and rules to stop people moving factories. In eastern Europe socialists and conservatives alike defend the right to compete on wages.

Look at politicians who did well in the elections, and many ran campaigns tailored exclusively to national concerns, hinting that outsiders are to blame for making life miserable. Angela Merkel in Germany spent the campaign saving German car factories belonging to Opel and arguing for tough regulation of hedge funds. No matter that hedge funds did not cause the financial meltdown. They are code for Anglo-Saxon capitalism, and thus a useful way of suggesting to German voters that their government is not to blame for the economic crisis.

Similarly, Nicolas Sarkozy of France painted a vision of a "Europe that protects"—the EU as a gigantic version of France, with an industrial policy and measures to penalise unfair foreign competition. Mr Sarkozy issued joint statements with Ms Merkel about the need to define the borders of Europe (ie, keep Turkey out) and the need for a common vision of EU economic policy (though, in reality, the French and German leaders strongly disagree about what to do over soaring budget deficits).

In Britain voters were also invited to blame their troubles on an outside menace, only in this case it was the EU itself. First place in the Euro-elections went to a Conservative Party that vows to claw back powers from Brussels; second to the United Kingdom Independence Party that simply wants to leave.

None of this is to deny that Europe could do with more democracy. The elections have shown that good things like the single market and open borders are under threat from populists and nationalists. Somebody must make the case to voters for preserving Europe's openness. Perhaps the European Parliament is not up to the job—just as cucumbers are not a good source of sunbeams. Maybe something different is needed, such as a bigger role for national parliaments. Investing more and more power in MEPs was always an experiment. When experiments fail repeatedly, it is time to try something else.

Economist.com/blogs/charlemagne

The survival of Gordon Brown

Stoppable force meets immovable object

Jun 11th 2009
From The Economist print edition

Labour's feeble and failed attempt to oust its leader

Guardian



BRITONS fearing for their jobs in the recession must wish for employers as indulgent as the parliamentary Labour Party. Observers assumed its patience with Gordon Brown, who already looked likely to lead it to a mauling at the next general election, would expire if Labour fared poorly at local and European elections on June 4th. In fact, the party plunged below even the worst-case forecasts: it now runs not a single county in England, and won less than 16% of the vote in the European poll.

The far-right British National Party (BNP) fed on the collapse of Labour support among the white working class (see article). Britain's growing antipathy to the European Union was also confirmed: over 55% of voters backed Eurosceptic parties, and a quarter hard-core anti-Europeans such as the UK Independence Party (UKIP), the BNP and Libertas. British pro-Europeans like to think their compatriots would warm to the EU if politicians would only make the case for it. After 12 years of a broadly pro-European government, that seems fanciful. Labour finished behind even single-issue UKIP: with turnout low, only one in 19 eligible voters backed the party in power. Even Wales, a Labour heartland, was lost to the Tories. Not since 1918 has a governing party won a lower share of the vote in a national election.

Yet still the prime minister hangs on. A summit with his MPs on June 8th saw much table-thumping loyalty. There are critics on the backbenches and some junior ministers have quit, grumbling about Mr Brown's uncollegiate style. But the only cabinet member who has resigned in explicit opposition to his leadership is James Purnell, who stood down as work and pensions secretary as the polls closed. In the ensuing reshuffle Mr Brown contemplated promoting his longtime adviser Ed Balls to chancellor of the exchequer, but decided not to provoke rebels who dislike the abrasive schools secretary. Alistair Darling remains at the Treasury. Some in the cabinet are thought to share Mr Purnell's doubts about Mr Brown, including David Miliband, who keeps his job as foreign secretary. None is keen to act.

It is not as though Labour looks absolutely doomed to be routed at the next election, whoever heads the party. The Tories' showing in the European election was only slightly up on 2004. They lead in the opinion polls, but there is little of the enthusiasm that garlanded Labour's path to power in the 1990s. A ComRes poll on June 9th suggested that Labour under Alan Johnson, the new home secretary and possible successor to Mr Brown, would deny the Tories an overall parliamentary majority. But Labour MPs fear that another unelected prime minister would have to go to the country soon. There is no constitutional bar to waiting until June 2010, by which time the recession and outrage over MPs' expenses may both have abated.

Mr Brown owes his survival to factors beyond his own indefatigability, among them Labour's unusual culture. More a tribe than a party, its members equate morality with loyalty rather than with principled dissent. MPs who still curse Ramsay MacDonald, a Labour prime minister, for entering government with the Tories in 1931 were hardly likely to follow a deserter, let alone one as relatively right-wing as Mr Purnell. Such solidarity is not as evident among Tories or Liberal Democrats, as defenestrated leaders of both those parties will attest.

Most of all, the prime minister can thank his long-serving team of advisers and fixers. Many of Tony Blair's inner circle—including Lord Mandelson, the business secretary, who is now indispensable to Mr Brown's survival (see article)—were public figures in their own right. Mr Brown's court remains largely unknown. Stalwarts such as Nick Brown and Ian Austin pummel away behind the scenes, rallying support and pacifying critics. The show of zeal by Labour MPs on June 8th was purportedly stage-managed by them.

This gift for politicking helped to see off rivals to Mr Brown's leader-in-waiting status during Mr Blair's 13 years in charge, as well as Mr Miliband's embryonic challenge last summer. But it has also backfired. Voters were appalled in April by a leaked e-mail from an aide suggesting personal attacks on Tories, a glimpse of the excesses of some Brownites. Mr Brown's reliance on back-room machinations may also have left other political muscles to atrophy, such as the ability to communicate with voters and design bold policies.

Loyalists insist that Mr Brown can revive Labour's fortunes by leading Britain out of recession, quickening reform of public services and overhauling politics. On June 10th he revealed plans to ponder a new electoral system, among other changes to Parliament and the constitution, and more are due. But this premiership has been relaunched before. Many will be tempted to agree with the Tories that Mr Brown's last-ditch enthusiasm for constitutional reform is an attempt to distract from the fiscal nightmare for which the chancellor-turned-prime minister himself is more than slightly responsible.

Yet it is mainly Mr Brown's inability to connect with voters that is doing for him, and here the great student of American politics could seek inspiration from a less obvious source than his beloved Kennedys. Allies of the prime minister resent the idea that the president he resembles most is Richard Nixon, another son of a God-fearing home with a big brain, a personality scarred by trauma and a taste for ruthless tactics. Nixon made a virtue of his squareness by siding with America's "silent majority" against the elites. Mr Brown, with his meritocratic history and indifference to money, should be able to define himself against nest-feathering MPs, cowboy bankers and posh Tories. But he will need an angrier tone than he found for the expenses scandal, while avoiding the clunking class war that helped Labour lose a by-election last year. Even that will probably not be enough to beat the Tories.

Mr Brown's enemies within have not given up either. The names of three cities will haunt him for months: Glasgow and Norwich, where defeats in upcoming by-elections could renew calls for him to go, and Brighton, where Labour's annual conference in September may see another attempted coup. For the time being, however, Labour stands by its man.

Economist.com



The BNP's breakthrough

Booted and suited

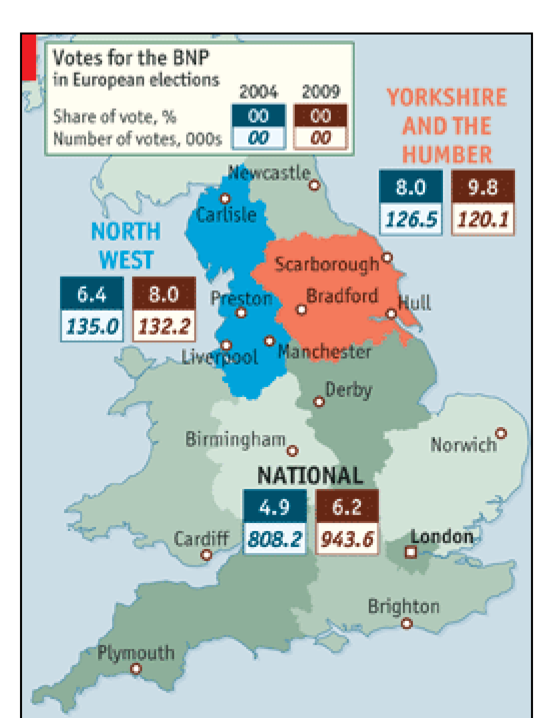
Jun 11th 2009
From The Economist print edition

Britain is not about to go fascist, but the BNP's success is worrying all the same

FAR-RIGHT political parties have often been regarded in Britain as more clownish than chilling—goose-stepping goons who somehow failed to notice that Britain, unlike its more volatile, susceptible continental neighbours, simply wasn't that kind of place. That complacent view has been tested, if not quite subverted, by the performance of the racist British National Party (BNP) in the European elections.

The BNP won two seats, in the North West and in Yorkshire and the Humber, for its leader Nick Griffin and Andrew Brons, a former chairman of the National Front. The party secured one place in the London Assembly in 2008, but neither it nor its ideological predecessors have ever won in a national poll, even in the 1930s.

True, the circumstances were extraordinarily propitious. A long unequal boom, which induced mass immigration, has ended in a slump. Meanwhile, mainstream parties have been savagely discredited by the scandal over parliamentary expenses. In this atmosphere the BNP, posing as unsullied avengers, might have been expected to do even better. Yet the party flopped in London (a failure Mr Griffin attributes to Labour activists "ferrying Africans who can't even speak English" to polling stations). It won fewer voters in the two Euro-regions it now represents than it did in 2004—but low turnout and a poor showing by others, particularly Labour, enabled it to creep across the proportional system's threshold. Far-right parties in Austria, the Netherlands, Italy and elsewhere were much more successful (see article).



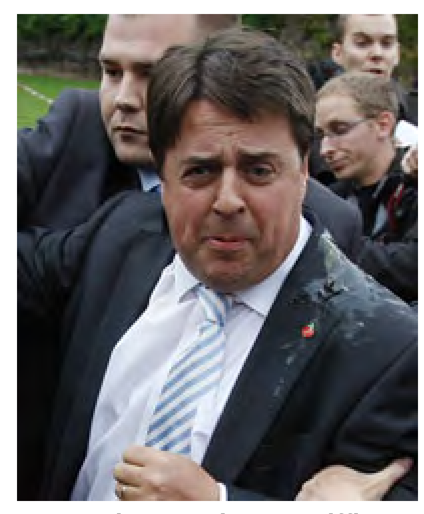
Reuters

But all that is only limited comfort to those who regard the BNP's breakthrough as distressing and shaming. It would be rash to assume that the big parties will recover to squeeze out the BNP in future contests. Its national vote rose, to 943,600 or 6.2% of the total (see map): a modest boost, perhaps, but from a base that was already worryingly high. It has performed relatively strongly in assorted elections since 2002.

Part of the explanation is the BNP's effort at rebranding. Several people involved in it, including Mr Griffin, have criminal convictions, in his case for inciting racial hatred. Membership is open only to "indigenous" Britons. But in public the BNP now eschews the crassest racism and claims to disavow violence. Instead it peddles Islamophobia (a "wicked, vicious faith", Mr Griffin has said), propagating tales of Muslim men "grooming" girls for sex. It is cannier at exploiting local grievances. Its platform includes a voluntary repatriation programme for immigrants, as well as withdrawal from the EU and the restoration of corporal and capital punishment.

But the BNP's coup also points to broader, structural trends in British politics. Its support is largely from poorly educated, white, working-class men, concentrated in ex-industrial towns in Yorkshire and Lancashire. Mr Griffin says most BNP voters are former Labour supporters. Its appeal rests on the failure of Labour and the Conservatives, at least under David Cameron, to satisfy that constituency. That in turn is a function of a

Westminster electoral system that requires parties to court swing voters in marginal seats and encourages the neglect of others. The resulting disenchantment and other factors—Celtic nationalism, the waning of class-based party loyalties—have fractured the main parties' old hegemony. The BNP is one beneficiary.



Not such a good egg, Griffin

Mr Griffin talks about seriously contesting "at least a dozen" seats at the next general election. That is laughably overblown, not least because Westminster's first-past-the-post system makes it much harder for them to win even one. And judging by their local councillors, BNP politicians tend not to distinguish themselves in office. But its two MEPs will undoubtedly raise their party's profile and funds. They will also change the way in which others deal with the BNP. Ignoring it is no longer a viable option; its specious policies will have to be openly challenged. The unspoken risk is that, rather than refuting the prejudices the BNP inflames, other parties will be panicked into pandering to them.

Economist.com


Reshaping government

Permanent revolution

Jun 12th 2009
From The Economist print edition

The cost of Britain's infinitely mutable government departments

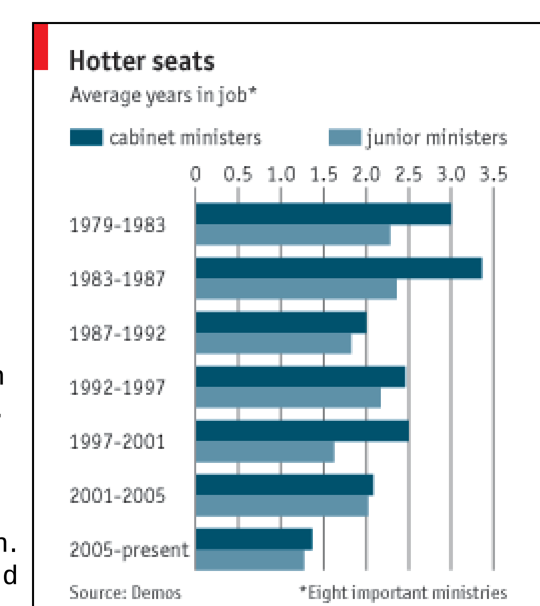
THE headed notepaper had barely been delivered and the glitches on the website ironed out. Now the Department for Innovation, Universities and Skills that was created in 2007 by the newly enthroned prime minister, Gordon Brown, is no more. Rather than rejoining the Department for Children, Schools and Families—the other half of what used to be the Department for Education and Skills—it is to join Business, Enterprise and Regulatory Reform (created that same busy summer from part of the old Department for Trade and Industry) in a new superministry for Business, Innovation and Skills.

The move bothers more than those prone to motion-sickness. Higher-education bosses wonder how congenial they will find a department created to "build Britain's capabilities to compete in the global economy". They fear a further shift towards naked utilitarianism, with fundamental research in science sidelined in favour of commercial applications. (And if particle physicists are fretting, imagine how poets and classicists must feel.)

Christopher Hood, a professor of government at Oxford University, thinks such departmental fission and fusion is often problematic. A split may be relatively painless if an entire unit is moved and the same people do the same job elsewhere. Some splits, though, are what he calls "ragged tears", which may have long-term benefits but are bound to be difficult for at least the first couple of years. As for bringing separate departments under one roof, even if it is designed to make policy more coherent and get people to work together, it may be decades before aspirations become reality. "The Ministry of Defence in its current form was stitched together from the separate military departments in the 1960s," he says, "and it's often said that even now you can see the joins."

According to Christopher Pollitt, a professor of public management at the University of Leuven in Belgium, structural change in central government is far more common in Britain than elsewhere. The first-past-the-post election system tends to produce single-party governments, meaning that the boss can shift ministers and meddle with ministries at will, without being constrained by the horse-trading over portfolios needed to form coalitions. And Britain's constitutional vagueness means that departments can be split and merged by fiat, rather than needing legislation.

So British prime ministers repeatedly give in to a temptation that is presumably felt elsewhere, but resisted. "They restructure for political symbolism," Mr Pollitt says, "or to reward or punish colleagues, or simply because family, say, is in the news this week, so a ministry of the family seems like a good idea." The resulting churn he calls "re-disorganisation".



Even when departments are unchanged, government is increasingly coming to resemble a game of musical chairs. On June 12th Demos, a think-tank, published research showing that average ministerial tenure has fallen steadily in recent years and is now just 15 months (see chart). Cabinet ministers last little longer. John Reid, to take an extreme example, had seven cabinet posts between 1999 and 2007.

Such turnover might be justified if it indicated tough quality control, with failing ministers dropped from government, says Demos's director, Richard Reeves, but ministers are rarely moved out, just on. Short tenures mean that they have little time to learn their briefs and less motivation to tackle entrenched problems; the ambitious ones tend to view jobs mainly as stepping stones to better ones. The think-tank wants to see a convention that ministerial appointments are for at least three years. If only the

departments last that long.

Suing the Omagh bombers

Justice, of a sort

Jun 11th 2009
From The Economist print edition

Frustrated in the criminal courts, victims' families gain a hearing in civil ones

TWENTY-NINE dead; 220 injured; one man tried; no one ever convicted of the crime. Yet on June 8th the families of victims of the 1998 bombing in Omagh finally had the satisfaction of seeing someone held accountable—if only by a civil court. Sir Declan Morgan, who is expected to become Northern Ireland's new Lord Chief Justice this month, ruled that four of the five men being sued by 12 relatives were indeed liable or responsible for the atrocity, and awarded the plaintiffs damages of £1.6m ($2.6m). The evidence against the fifth was declared unreliable. On June 10th Michael McKevitt, one of the four, said he would appeal against the ruling.

This is thought to be the first time anywhere in the world that relatives of terrorists' victims have obtained redress in a civil court. The defendants had tried, and failed, to have the case reclassified as criminal under the European Convention of Human Rights, which guarantees the right to a fair trial. The plaintiffs did not need to prove criminal charges to claim compensation, stressed Sir Declan, just that they had been harmed by personal injury or trespass. Others, including families of some of those killed in the London bombings in July 2005 may follow suit.

Other new ground was also broken. Damages may be sought from a terrorist organisation, not just from individuals, the judge ruled. Two of the men were sued both personally and as representatives of the Real IRA, the splinter republican group that had admitted responsibility for the atrocity. The judge made a "representation order" against one of them, declaring that he had been on the Real IRA's "army council" at the time of the bombing. That means damages could be sought from anyone who was on the council then, or from the Real IRA itself—a possibility the families' solicitor said they would "pursue vigorously".

"This was not about the money," said Michael Gallagher, whose 21-year-old son Aidan died in the bombing. The defendants have had years to arrange their affairs—although the representation order potentially makes other people liable too, and the criminal-assets bureau in the Irish Republic, where all four men live, has particularly fierce powers to seize the proceeds of crime or terrorism.

In 2007 Sean Hoey, the only person ever to be tried for the atrocity, was acquitted in Belfast. And last year the Northern Ireland Policing Board admitted that unless new evidence emerged, it was unlikely anyone else would ever be charged. "We have proven," said Mr Gallagher, "that if the criminal-justice system is not capable of delivering some justice, at least civil law is."

Secret evidence in court

Time to show your hand, or fold

Jun 11th 2009
From The Economist print edition

Suspects must hear the case against them or go free, judges say

YOU may not leave your home between 5pm and 9am; you may not receive visitors without permission; you must wear an electronic tag at all times. Those are among the requirements that have been imposed on 40 people over the past four years through "control orders", restrictive conditions that the home secretary may place, with the agreement of a judge, on anyone he believes to be a terrorist. Seventeen people, including British citizens, are restricted in this way at the moment.

Three such cases were the subject of a ruling by the House of Lords on June 10th that will change the operation of control orders—and perhaps much else besides. At issue was the way in which evidence given at control-order hearings can be kept secret from the defendant and his counsel in order, it is said, to protect flows of information important for national security or the health of the source. A security-vetted "special advocate" is appointed on the defendant's behalf to hear evidence and cross-examine witnesses in private. The advocate may not communicate with his client thereafter, which prevents him from asking if the defendant has an alibi for a certain date, for instance, or can explain a particular phone call.

Someone who has done nothing wrong is left wondering what he is accused of, and struggling to provide a defence (the guilty have some idea of what they must explain away). Even the judge's detailed ruling is kept secret; a vaguer version is released for public consumption.

Their lordships ruled that this system would not do. "A trial procedure can never be considered fair if a party to it is kept in ignorance of the case against him," wrote Lord Phillips, the senior law lord on the case. Secret evidence may continue to be used, the lords ruled, but defendants must get a good enough gist of the case against them to be able to rebut it. In practice, the Home Office might drop some cases rather than contest them in public and thereby risk revealing sources or spying methods. Eric Metcalfe, the director of Justice, a lobby group, reckons that about half of the control orders now in place might be lifted as a result of the ruling.

There will be further consequences, for the use of secret evidence has spread widely in the past decade. A report by Justice released at the same time as the lords' ruling outlines how secret evidence has spread from immigration hearings (in 1997), to the detention of terrorists (from 2001), to parole-board hearings (in 2002) and, since 2006, to the freezing of suspected terrorists' assets.

Few Western countries are as relaxed about secrecy in court. Australia's approach is similar to Britain's, and "investigating magistrates" in civil-law countries such as France may provide summaries of spies' intelligence that omit some details. But in the use of secret evidence and special advocates, "Britain is the pioneer," says Ben Ward of Human Rights Watch, an international lobbying group.

The curiosity is how Britain has ended up with this approach. "In some ways, the UK is in this position because it tried to take the enlightened step of giving the courts some control of this secret material," Mr Metcalfe says. The use of secret evidence in court dates back to the creation of a special tribunal in 1997 to handle appeals by people who were being deported for national-security reasons. Until then, such folk had been booted out without much of a hearing, as they were in most countries. But a ruling by the European Court of Human Rights in 1997 that this rough justice violated their right to a fair trial prompted the government to set up a quasi-judicial commission for such cases, in which some evidence was kept secret and special advocates were used.

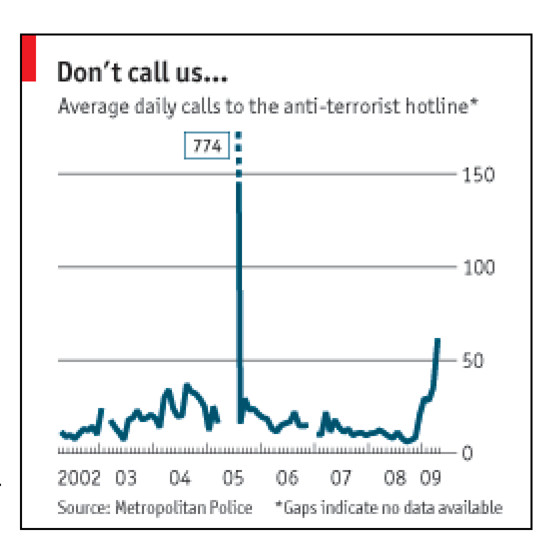
This compromise was not ideal, but it was fairer than most other countries' approaches. (A decade on, Denmark is considering adopting the British model for its deportation appeals.) Alas, it created a template that was later applied to kinds of cases that would never normally have hinged on secret evidence. Now, perhaps, the trend will be reversed.

The anti-terrorist hotline

Not very hot

Jun 11th 2009
From The Economist print edition

A traffic-cone hotline for our times?



POOR Gordon Brown's premiership is often compared these days to that of John Major, bogged down by a mutinous party and a dissatisfied electorate. Mr Major's uninspiring government is still remembered for its "cones hotline" initiative, which gave motorists a number to ring to report misplaced traffic cones. The line was shut down after three years in which only a few thousand people bothered to call (some of them, supposedly, to order ice-cream).

Now *The Economist* has discovered an even lonelier switchboard. It belongs to the "anti-terrorist hotline", which members of the public are encouraged to ring in order to report suspicious behaviour. Given that the police suggest fingering people who have a lot of mobile phones, for instance, or who are vague about their travel plans, one might expect the hotline phone to be ringing off the hook. In fact, for the past three years it has trilled just 15 times a day, on average—less often than even the lowly traffic-cone hotline.

Volumes surged in July 2005, after terrorists bombed London (see chart). And the past two months have been busy, following a national advertising blitz costing £1.8m, most of which came from the centrally funded Association of Chief Police Officers. The Metropolitan Police, which runs the hotline, can't say quite what it costs to operate because the staff who man it have other roles too. But since 1999 the Met has spent £3.1m on publicity, in addition to a contribution to the latest campaign. Britain's 51 other regional forces may have spent more.

It seems a lot for a line that, in one month last year, rang only six times a day. Perhaps the latest advertising campaign will have a lasting effect. And of course, one good tip could make it all worthwhile. Police sources point out that a gang of terrorists was arrested in 2005 after a caretaker spotted bottles of hydrogen peroxide in their rubbish. Did this, or any other useful tip, come via the hotline, though? The police wouldn't say, for security reasons.

Public and private pensions

Worlds apart

Jun 11th 2009
From The Economist print edition

Britain's pensions apartheid looks unsustainable

COMPANY final-salary schemes were set on the path to extinction earlier this decade following a wave of closures to new recruits. Now BP, one of a handful of big firms that stood apart from the crowd then, is following suit. Even more strikingly, Barclays is planning to close the bank's scheme for its existing members.

Corporate Britain is abandoning final-salary plans because they have become too expensive and risky. By providing a defined-benefit (DB) pension based on end-of-career earnings and years of service, employers pay for investment shortfalls and rising longevity. By contrast individuals shoulder this burden under the alternative arrangement of defined-contribution (DC) plans, in which they build up a fund to purchase a pension. Employers generally pay much less into these than they do into DB schemes.

If any one British company seemed to be in a position to defy this trend and maintain final-salary pensions, it was BP. In deciding to close its scheme to new members from April 2010, the oil behemoth cited in particular its concern that liabilities were being driven up by greater life expectancy. Instead, new staff will receive a "flexible allowance" worth 15% of basic salary, which can be used either for a DC plan or for other purposes (such as paying off loans).

Getty Images



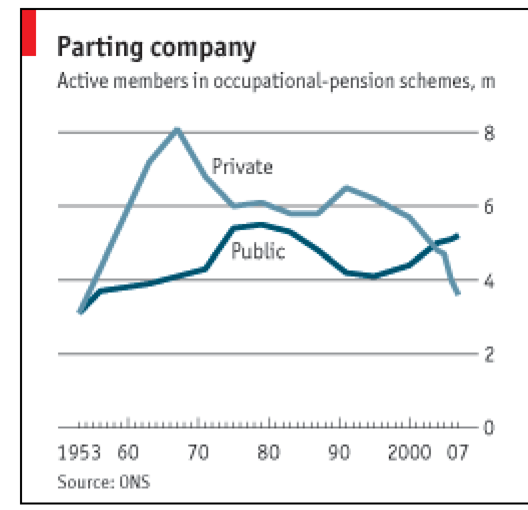
Who will temper the wind to the shorn lamb?

Yet it was the move by Barclays that workers should find more ominous. Until now most big employers closing their schemes to new recruits have kept them open for staff who had already joined. This meant that they continued to accrue extra pension for additional years of service. Rentokil, a business-services firm, announced in December 2005 that it would close its plan for such workers, but it was the exception. Now Barclays is proposing to stop future accruals for its 18,000 existing members from December.

The effect will be to freeze retirement benefits already earned, since they will be based on current salaries uprated for inflation. That will typically produce lower pensions than if the payout had remained linked to final salaries, which would incorporate wage progression from general pay rises and promotions. Staff are being offered the same alternative for their future pension provision as new recruits, a "hybrid" plan that combines a DC component with a promise to pay a guaranteed sum of money into the account at retirement. Despite this, it remains a money-purchase arrangement and is much less generous than the final-salary scheme, says John Ralfe, a pensions consultant.

The accelerating demise of final-salary schemes provided by companies contrasts with their rude health in the public sector. As recently as 2000, there were more employees building up pension

rights—“active members”—in private occupational schemes than in the public sector (see chart). Four years later the tables had been turned, even though public workers make up only a fifth of total employment. By 2007 the number of active members in the private sector had fallen to just 3.6m, of whom 2.7m were in DB schemes; of these just 1.3m were in schemes still open to new recruits. By contrast there were 5.2m active members in the public sector, overwhelmingly in DB plans that remained open.



As the Pensions Commission pointed out in 2004 when it was investigating the general health of British pensions, public schemes are collectively far more generous than those available to private-sector workers. It estimated that the public sector’s share of occupational and personal pension wealth was double its share of total earnings in the economy. Grumbles about this disparity sparked some half-hearted reforms to trim the big unfunded public schemes. The retirement age for new workers was raised to 65 but, crucially, was left untouched for existing employees.

This pensions apartheid may change, however, as worries about the government’s finances intensify because of supersized budget deficits. A report on June 11th from Policy Exchange, a right-of-centre think-tank, puts the cost of unfunded pension obligations to public-sector staff at £1.1 trillion, equivalent to 78% of GDP and higher even than Britain’s ballooning public debt. Such valuations are sensitive to the choice of discount rate used to convert future pension payments into today’s money. But even official government estimates have put the cost of these off-balance-sheet liabilities at around 50% of GDP.

Whatever the precise worth of the pension promises, the arrangements in the public sector are manifestly more generous than what is now generally available in the private sector. The row over expenses has obscured the fact that MPs themselves enjoy an extraordinarily lucrative pension package. An austerity budget is looming after the general election due within a year, whoever wins it. Public-sector pensions are an obvious target.

Bagehot

Peter's pet

Jun 11th 2009
From The Economist print edition

How, why and with what consequences Lord Mandelson kept the prime minister in his job

Illustration by Steve O'Brien



DURING the general-election campaign of 1997 Peter Mandelson made a public appearance with a bulldog. The dog, whose name was Fitz, supposedly embodied patriotism and resolve: "It is a completely New Labour dog," Mr Mandelson explained. Fitz was a truculent beast, straining on the leash and inopportunely lying down. Twelve years later Lord Mandelson, as he is now, has another pet. This one also tries, not altogether persuasively, to embody Britishness and determination. He too is Lord Mandelson's creature. His name is Gordon Brown.

In retrospect it is clear that, during the crisis that engulfed Mr Brown after the European elections, only his cabinet could have forced him out. He was saved by the senior members of it who stayed loyal: David Miliband, the foreign secretary; Jack Straw, the justice secretary; Alistair Darling, the chancellor of the exchequer; Alan Johnson, now the home secretary; and above all Lord Mandelson, the business secretary. He reputedly bound in some colleagues after James Purnell spectacularly quit as work and pensions secretary. He was a bulwark against further Blairite defections. This fidelity kept Mr Brown in government. It will also change his government.

Consider the manner of the rescue. There was a certain amount of chatter about how Mr Brown was a titanic figure, an economic alchemist, and so on. But Lord Mandelson—whose 14-year estrangement from Mr Brown ended only when he was astonishingly brought back into the cabinet last year—is too canny an operator to have believed that such panegyrics alone would wash. The arguments advanced for keeping Mr Brown were often negative: that a putsch would make Labour's plight worse; that a devastating general election would follow in short order.

It is not true, in politics at least, that everything that doesn't kill you makes you stronger. Mr Brown survived only at the discretion of his colleagues, and less because of his virtues than because of the risks of ditching him. He was not damned with faint praise: he was saved with almost no praise. The result of that lukewarm mercy is that power has been redistributed. Where once Mr Brown seemed to have no internal rivals, the ministers who could have finished him off now have a stronger hand. They cannot be sacked. They may have more freedom to make policy.

This is both bad and good news. At a time when Britain is struggling with the Taliban, a recession and an

imminent debt crunch, for it to have so diminished a prime minister is alarming. Mr Brown still has a parliamentary majority of a kind John Major eventually lacked, but he is almost as emasculated. Yet one effect could be to restrain Mr Brown's inclination and ability to build a political recovery on profligacy. Mr Darling, for example, is said to have helped prevent the economic predictions in April's budget from being even more fanciful. He may now be in a better position to promote the fiscally responsible policies that, more than Mr Brown, he has seemed to realise are necessary.

The senior loyalists may also counteract pressure from the newly perky Labour left, who see in Mr Brown's weakness a chance to sway him their way. (One of his loudest defenders has been Ken Livingstone, the lefty former mayor of London and an even more improbable Brownite than Lord Mandelson.) For his part, Lord Mandelson is a more zealous believer in public-service reform than the prime minister has seemed. He says that cause, which had seemed to stall, will now advance.

In 1997 Tony Blair pledged that since his party was elected as New Labour, it would govern as such. After a hiatus in the past year, it may be defeated on a recognisably New Labour platform too. Like Fitz, Mr Brown may henceforth be a New Labour dog.

So much for how Mr Brown was saved, and to what effect. The other big question is, why? In mercenary terms, most of the saviours sold their loyalty cheaply. Three retained their previous roles (albeit, in Mr Darling's case, one he had seemed set to lose). Mr Johnson, who in theory might have been prime minister, gained what is notionally one of the great offices of state, but one that breaks more careers than it makes. Only Lord Mandelson is an obvious winner. He oversees a new superdepartment, boasts almost as many titles as the monarch and has huge sway over strategy. Observers have often attributed vast, hidden influence to him. Sometimes they have exaggerated. Not any more.

A dish served cold and every day

The gang's motives, however, and perhaps Lord Mandelson's especially, were more complex than a simple calculation of personal self-interest or lust for verbose kudos. It is sometimes said that the makers of New Labour commandeered the party simply to achieve power. In Lord Mandelson's case, that is nonsense. He was born into the party (his grandfather was deputy prime minister in the Attlee government), and spent much of his life making it electable. Some of Mr Brown's assailants also love their party, and wanted to bring him down to save it. Right or wrong, Lord Mandelson and some of the others disagreed, and truly thought keeping Mr Brown was Labour's least bad option.

But the cynical might wonder whether there is a further, unconscious element to his motivation. The official line is that he and Mr Brown have buried the hatchets they once deployed against each other, and revived the understanding they shared before their falling out. Perhaps; but perhaps his succour itself contains a subtle form of vengeance. Lord Mandelson could easily have destroyed his erstwhile foe. Yet to a refined palate, the one-off rush of bringing down an old adversary might seem a crass and unsatisfying triumph. How much more gratifying to hold his fate in your hands every day—and he knowing you own it? It is a turn of events that, before he became prime minister, Mr Brown cannot have anticipated in his worst, wildest dreams.

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Economist.com

The UN's secretary-general

The score at half-time

Jun 11th 2009
From The Economist print edition

Ban Ki-moon has turned in a mixed performance so far. He needs to improve

Illustration by David Simonds



THE first secretary-general of the United Nations told his successor it was the toughest job in the world. It has since got harder. Halfway through his first five-year term, Ban Ki-moon, only the eighth man to fill the post (there have been no women), still struggles to make his voice count in a cacophonous world. South Korea's foreign minister before moving to the East River, Mr Ban has made his country proud. He shows signs of wanting a second term; some wonder whether he deserves it.

The UN was created to set and uphold norms on everything from human rights to (lately) terrorism and climate change, to resolve crises, keep the peace, alleviate poverty and encourage development. In fact, as Mr Ban has found, managing relations with the UN Security Council and the General Assembly is like trying to run a company with a divided 15-member board, while keeping 192 querulous shareholders from each others' throats—and his own. Getting a grip on the UN's vast array of agencies, commissions, programmes and envoys is a management job from hell.

Mr Ban is also expected to man the bully pulpit. On behalf of "We the peoples"—as the UN charter has it—he is supposed to prod governments, especially the big powers, to keep their lofty promises.

For a time, admirers hailed Mr Ban's predecessor, Kofi Annan, as a "secular pope", ready to speak up for those in need of UN succour. But his authority sagged after people close to him were found to have mismanaged and even profited from a UN oil-for-food effort in Iraq.

Mr Ban set out to project a different image: industrious, diligent—and to the chagrin of many, cautious. Indeed Mr Ban got the job in 2007, in a deal brokered by America and China, because he was not the head-over-parapet sort. That disappoints many: more "secretary" than "general", as wags have it. So how is he doing?

- **Truth to power: 3/10** There is nothing wrong with quiet diplomacy if it gets the job done. Mr Ban's low-profile efforts got humanitarian aid into Myanmar after the cyclone where others failed. All the same there is a sense that he ducks too easily, too often.

After a tough word with Robert Mugabe produced a tongue-lashing in return, say insiders, Mr Ban did his darnedest never to upset Zimbabwe's despot again. Similarly he tries not to cross the Russians, who are also prone to throwing tantrums.

Mr Ban is hoping for re-election; indeed, he keeps score of the miles he travels and the hands he shakes. Partly for that reason, say UN-watchers, he tries not to offend China over the conflict in Darfur, and over efforts by the International Criminal Court to arrest Sudan's president, an ally of China's, on war-crimes charges. Not wanting to annoy America, Israel's chief ally, Mr Ban also largely kept his head down over the fighting in Gaza.

After Sri Lanka's war ended, Mr Ban denied that the UN had leaked grim civilian casualty figures (indeed, some UN officials reportedly sought to suppress the toll). That obscured his other responses—such as an appeal to aid the Tamil refugees. With Sri Lanka's government shielded by China, India and others at the Security Council and at the UN Human Rights Commission, human-rights groups had hoped Mr Ban would speak up more for the victims.

- **The bigger picture: 8/10** To his credit, climate change was Mr Ban's early priority. He brought together government heads and nudged their officials along when agreement seemed elusive, putting his best Secretariat brains to work on the issue. When the food crisis erupted, he quickly knocked heads together so that various bodies, including the World Bank and the World Food Programme, could co-operate and help vulnerable countries. Yet the credit crunch has again pushed the UN to the sidelines.

- **Keeping the peace: 6/10** Mostly Mr Ban can exhort and facilitate, unable to do much if others resist. But peacekeeping operations, once mandated by the Security Council, are under his control. The UN now has about 113,000 blue helmets and other personnel on the ground (twice the number of 15 years ago) and is managing 18 missions around the globe; the strains are showing. In Congo its largest peacekeeping effort has been dogged by indiscipline. When violence flared again recently in eastern Congo, it was caught flat-footed, lacking intelligence and barely able to defend itself, let alone protect civilians.

That is supposed to be changing. Mr Ban has split the peacekeeping department in two. A new under-secretary for field-support operations, an energetic Argentine, Susana Malcorra, gets boots and kit on the ground; this frees the overall head of peacekeeping, Alain Le Roy, to run missions and do the politicking. Their staffs do not co-operate as well as their bosses do, but if anyone can get cash out of mean governments to put peacekeeping on a firmer footing, it is Ms Malcorra.

- **Management skills: 2/10** Mr Ban cuts an isolated figure, cut off by an inner circle of mostly Korean advisers. Communication with senior staff is poor, and since Mr Ban is not a good listener, it is hard to harness their expertise. What is needed is some leadership from Mr Ban and some clear goals to aim at.

There is lots for him to do: making the bits of the UN work together across a wider range of issues; drumming up more peacekeepers; and getting rich countries to help poorer ones meet the Millennium Development Goals. Time is running out.




Conserving forests

REDDy and waiting

Jun 11th 2009
From The Economist print edition

Some odd documents from Papua New Guinea show how hard it is to save trees

AP



Even in Bonn, it's getting warmer

THESE are critical times for trees. In some places—like Peru, where police and indigenous folk are doing battle—the future of the forests is being determined by lethal force. Guyana is seeking money from the rich world to help keep most of its land forested. In other places, eco-warriors merely have to hack their way through a thicket of arcane technicalities. One such place is Bonn, where diplomats from most countries in the world are haggling over financial incentives to keep trees intact.

War-war in Peru is more gripping than jaw-jaw in Bonn, but the latter affects the earth's future too. The talks are working on details of an idea known as Reduced Emissions from Deforestation and Degradation (REDD): it aims to fold the saving of trees into a wider UN effort to cool the world.

At the moment, the UN system offers no rewards for leaving trees alone. True, carbon belchers in the rich world have the right to offset their emissions by paying for activities in the poor world that help retain carbon, under a deal called the Clean Development Mechanism (CDM). Those activities can include planting new trees, but not saving old ones from the chop.

That makes no sense, all the more so given that old forests are better at storing carbon than new ones. A global gathering in Copenhagen at the end of the year will probably put that right—by bringing standing forests into the climate-change game, and into the global carbon-trading system.

Whether for ethical reasons, or to get a toehold in what will soon be a vast global market, institutions and individuals have started investing in "voluntary" efforts to keep trees intact, outside the UN framework. This voluntary market was worth $335m in 2007, and $705m in 2008, says Ecosystem Marketplace, a consultancy.

But how can people know that cash for trees (via the UN or other channels) is having the right effect? One criticism of the CDM is that it creates perverse incentives for bad behaviour, whose cessation is then presented as "saving" carbon. Won't REDD have odd side-effects too? A big problem with many versions of REDD is that they rely on efficient, accountable governance in rainforest countries, where the prospect of a new multibillion-dollar market in forest credits is already causing a stir. Good governance is not always evident in REDD-supporting countries like Papua New Guinea, which is leader of the Coalition for Rainforest Nations.

Papua New Guinea's government is probing reports of "irregularities" at the Office of Climate Change (OCC), a state agency that is asserting the right to deal in promises of forest preservation: pledges that may soon be worth a lot of money.

And there are things to look into. *The Economist* has seen a document, apparently signed by the office last November 3rd, which purports to certify the preservation of 1m tonnes of carbon under the UN's REDD arrangement. It vows that a "carbon sink" in the Kamula Duso region will stay intact till the certificate matures in 2012.

At least two things about this document raise eyebrows. It implies that the REDD system now exists; and it offers a promise about the Kamula Duso forest which nobody can make until the outcome of a court case to settle who owns it. Further investigation suggests that at least 39 more "REDD credits"—each

“guaranteeing” 1m tonnes of carbon—were issued by the OCC, covering up to a dozen forests.

The Kamula Duso credit was one reason for a crisis meeting in May of the country’s local governors, who want an audit of the OCC. They said it should be stopped from issuing further credits or approving carbon-trading deals. They urged Norway and Australia, as well the European Union and the UN, to stop conservation aid to Papua New Guinea until the truth is known.

Sir Michael Somare, the prime minister, accepts that if the OCC was issuing REDD credits, it was out of line. His press secretary (and daughter), Betha Somare, says it “has no legal mandate to issue forest carbon credits other than afforestation and reforestation through the CDM, nor is there currently any REDD asset in existence because of the lack of a regulatory framework for forest carbon in Papua New Guinea.” When shown a copy of the Kamula Duso credit, she said: “Very recently, apparent irregularities within the OCC have come to our attention. As a result the prime minister asked for a review to be carried out, and a report to be made to his office.”

In the world of finance and among greens, the Papuan saga is being watched closely. It underlines the need to get the details of REDD right: who will be paid for what? Who can promise what?

A well-designed REDD could be “the gourmet niche” of the carbon markets, allowing ethical investors a chance to save biodiversity and indigenous people as well as carbon, says Abyd Karmali, head of carbon trading at Merrill Lynch. But an ill-crafted REDD could be at the “junk end of the risk spectrum”. Andy White, an activist with a campaign group called Rights and Resources, calls the Papuan affair a “deeply worrisome” wake-up call for the Bonn negotiators. In Papua New Guinea, he notes, the right of local people to control their forests is in theory clear—but a state agency seems to making deals over their heads.

The Bonn talks are inching forward. It is increasingly accepted that a decent REDD system must help places (like Guyana) that have always conserved trees, not just reforming sinners; and the idea of rewarding forest-owners for benefits other than carbon storage (like biodiversity and rainfall regulation) is gaining ground.

None of this can bring instant peace to rough parts of the Amazon, or instant political calm to Papua New Guinea, where a new study says half the trees will have gone by 2021. But with a good REDD system—rewarding governments and locals alike for saving trees—blood might not be flowing now in the jungles of Peru.

Holding together

Jun 11th 2009
From The Economist print edition

The euro area, sorely tested by the financial crisis, has survived intact and is likely to expand further, says John O'Sullivan (interviewed here)

Illustration by M. Morgenstern



IN THE mid-1980s *Rolling Stone* magazine published an essay by P.J. O'Rourke, a conservative American humorist, with the splendid title "Among the Euro-Weenies". In it the author poured scorn on Europe, an annoyingly fractured continent with its "dopey little countries", "pokey borders", "itty-bitty" languages and "Lilliputian" drinks measures. The mosaic of countries made the visitor feel claustrophobic: "You can't swing a cat without sending it through customs," he complained.

He will not have been aware, or cared much, that plans were already in train to give "Europe" the continental scale it so painfully lacked, as well as a currency that would rival the dollar. In 1986, the year of Mr O'Rourke's visit, the European Economic Community (as the European Union was then known) expanded from 10 to 12 countries, with the addition of Portugal and Spain. Its members had spent most of the 1970s erecting non-tariff barriers to internal trade, and the early 1980s battling over who should pay for its joint budget (a fight which, to be fair to the others, Britain started). With that settled, there was a fresh desire to make progress towards a genuinely open free-trade block.

The first fruit of that effort was the Single European Act, an agreement to dismantle barriers to internal trade by the end of 1992. A rider to the act sketched out an ambition to complement the single market with a single currency. Few took that seriously, least of all British politicians, who had signed up to the act with enthusiasm because they were keen free-traders, but dismissed the grander kind of Community rhetoric as "euro-guff".

An idea whose time had come

Yet by the time a 1991 European summit was held in the Dutch city of Maastricht, a plan for economic and monetary union (EMU) was written into a new EU treaty, to be ratified by member states later. That the proposal had gained ground so swiftly was a surprise to many. The British government had thought that a committee of EU central-bank governors, charged in 1988 with studying if monetary union was feasible,

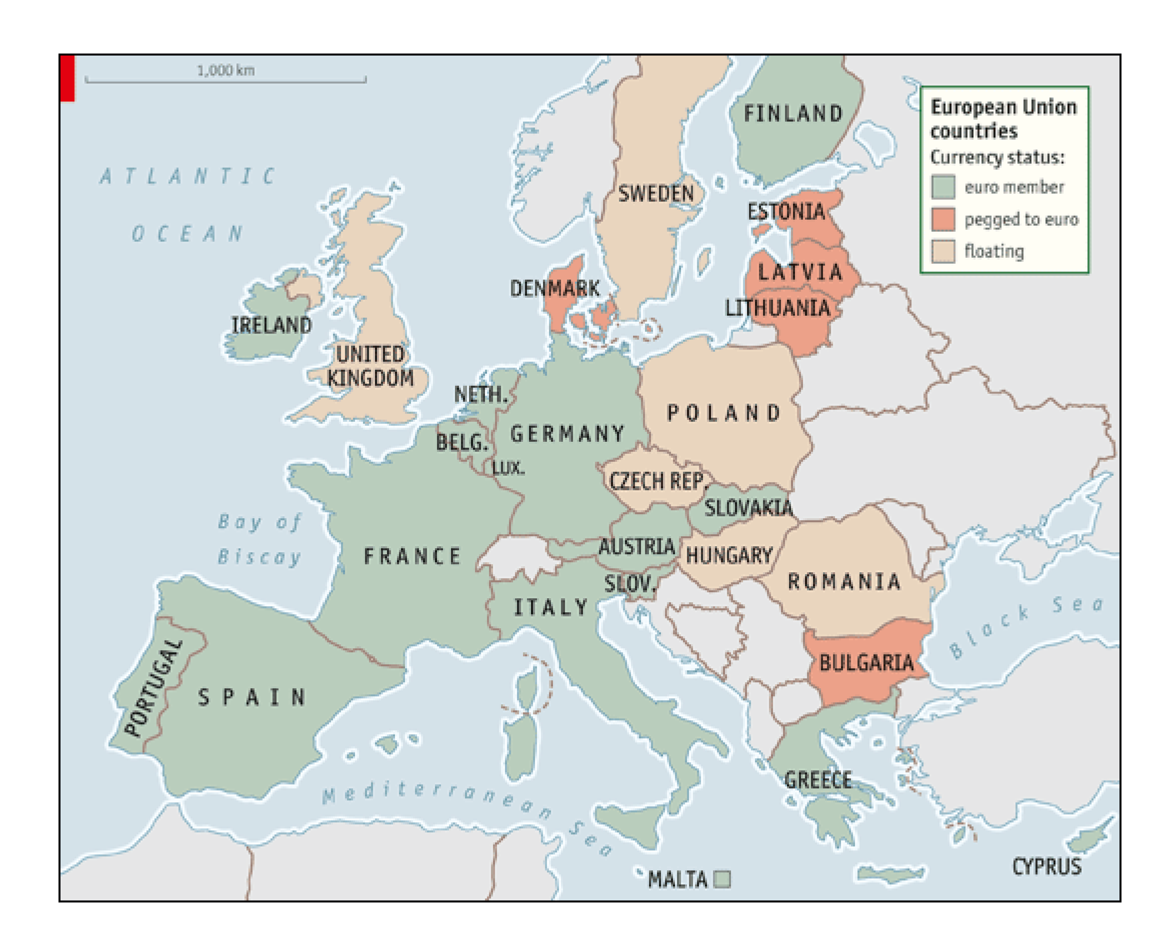
would quash the idea. Instead the group, chaired by Jacques Delors, then president of the European Commission, the EU's executive branch, gave it qualified approval.

The Delors Report concluded that EMU could work if control of the single currency was kept from meddling politicians and left to independent technocrats at a European central bank, to be modelled on Germany's Bundesbank. The report gave warning, however, that to prevent large trade imbalances, reforms would be needed to make prices and wages more flexible and workers and capital more mobile.

EMU's route from rhetoric to economic blueprint was a familiar one, if unusually swift. The push behind trade integration in Europe has been primarily political rather than economic. The EU itself was born of the catastrophe of two world wars, collisions of competing nation-states. It was designed to avoid a repeat of such conflicts by forging "ever closer union" in Europe. Economic ties were viewed as much as a means to co-operation as an end in themselves. The Delors Commission between 1985 and 1994 marked the zenith of this sort of integrationist zeal.

After many a flap (see article), EMU eventually metamorphosed into a bird of much grander plumage. On January 1st 1999 the currencies of 11 countries were fixed against a new currency, the euro, which became the unit of reckoning in wholesale financial markets. In 2002 euro notes and coins came in and the old paper currencies were phased out. Since the single currency's launch five more countries have joined the euro area. In a unique economic experiment, 16 countries with a combined population of 329m have handed over monetary sovereignty to an entity at arm's length from national politics: the European Central Bank (ECB).

So far the experiment has worked fairly well. The ECB has fulfilled its remit to maintain the purchasing power of the euro. Since the currency's creation the average inflation rate in the euro area has been just over 2%. Fears that the euro would be a "soft" currency have proved unfounded. It is unquestioningly accepted at home and widely used beyond the euro area's borders. (Several countries, including Montenegro and Kosovo, use the euro as their currency without formally belonging to the euro zone.) The switch from old currency to new went remarkably smoothly, though consumers in many countries complained, perhaps predictably, that they were charged higher prices as merchants rounded up to new price-points in euros. But this caused barely a blip in the official inflation figures.



So far the euro has brought neither greater prosperity nor political union. Job-creation improved but productivity increases slowed, leaving the region's trend growth rate much the same as before EMU. In its early years the euro fell against the dollar, but it has since more than made up for its early losses. It has

quickly established itself as a global currency without becoming a true rival to the greenback's status. For much of the euro zone's first decade Germany, its largest economy, was in the doldrums, but after a long period of wage restraint its export industries started to lift the economy. Spain, Greece and Ireland proved more dynamic, each enjoying a consumer boom.

All seemed well until the present financial crisis struck. This reawakened worries about the imbalances that have built up inside the euro zone. Germany's huge current-account surplus is matched by big deficits elsewhere, particularly in the Mediterranean countries that German policymakers had been so keen to exclude from joining. It remains an open question how these will be resolved.

The financial crisis is proving by far the biggest test to date for the euro zone. This special report will look at its effects on the euro area and consider whether such a disparate group of countries can continue to share the same monetary policy. It will ask whether the crisis will spur economic reform and whether it will attract more members to the club or, conversely, whether some of them might be thinking about leaving. Lastly, it will examine the idea that in the longer term a multinational currency area will require greater political union to function properly.

A tortuous path

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From Bretton Woods to euro

THE idea of a single money as a path to European political union goes back a long way. In the 1950s a French economist, Jacques Rueff, wrote that "Europe shall be made through the currency, or it shall not be made." But the euro had pragmatic roots too. After the breakdown of the Bretton Woods system of fixed exchange rates in 1973 the Deutschmark emerged as the benchmark currency in continental Europe. The instability of floating currencies was a barrier to harmonious trade, but schemes to peg exchange rates frequently had to be redrawn because few countries could consistently match the Bundesbank's anti-inflation zeal. The might of German manufacturing forced frequent devaluations on others to keep their industries competitive.

Changes to exchange-rate pegs often caused tensions. François Mitterrand, who as French president was one of the signatories of the Maastricht treaty, is said to have remarked that "devaluations are never small enough to avoid losing face and never large enough to make a real difference to exports." As soon as Maastricht had been signed (with a British opt-out from EMU), those tensions resurfaced. In June 1992 the Danes voted narrowly against ratification, raising a question mark over the assumption that the path to EMU would be smooth. The Irish, in the only other scheduled referendum, voted in favour shortly afterwards, but Mitterrand announced a referendum in France for the following September, a risky gambit because French public opinion was cooling on monetary union.

Currency markets were also stirring. At the time all 12 EU countries, bar Greece, were in the exchange-rate mechanism (ERM), a system that tied currencies to each other within narrow trading bounds. Germany was at the scheme's heart: currencies were officially pegged to each other in a complex grid of bilateral rates but all were, in effect, tied to the D-mark. That became a problem when economic conditions in Germany and the rest of Europe diverged. To head off inflationary pressures caused by Germany's post-unification boom, the Bundesbank in July 1992 raised interest rates to 8.75%, a 60-year high.

Those German rates caused strains in currency markets that worsened over the summer. In September first Italy and then Britain were forced to devalue, in Britain's case after spending billions of dollars trying to defend its ERM parity against speculators. In the following months Spain, Portugal and Ireland too had to let their currencies slide. France battled to hold to its parity and only just succeeded. Its referendum produced a narrow vote in favour of the Maastricht treaty.

Look at it this way

Different countries learnt different lessons from the crisis. Britain saw dangers in fixed exchange-rate schemes. Its economy started to pick up almost immediately after its ejection from the ERM. The French were confirmed in their belief that a monetary union was necessary both to prevent speculative attacks on currencies and to ensure that Europe's monetary policy was not made exclusively in Germany. Some German policymakers, previously sceptical of EMU, fretted that any repeat of the crisis would be a threat to the single market.

It was residual German scepticism that caused stiff tests to be set up for countries that wish to join the euro. The "convergence criteria" set out in the treaty called for would-be joiners to meet targets for inflation, bond yields, exchange-rate stability, budget deficits and public debt. The criteria were criticised as having little to do with a country's ability to cope once monetary policy was no longer tailored to national needs. Instead, they seemed designed to favour a core group of like-minded countries, centred around Germany, and to exclude others, particularly Italy, which it was feared would use EMU's low interest rates to relax fiscal discipline.

Things turned out differently. By 1997, the year in which the tests would be applied to a first wave of would-be entrants, Germany and others in the core group had trouble fitting into the Maastricht straitjacket

themselves. The time scale for the fiscal targets had to be fudged, which let Italy and others slip through. France insisted that the "stability pact" proposed in the treaty be renamed "stability and growth pact". Germany demanded a cap on budget deficits of 3% of GDP. When both countries themselves later breached that limit, the rules had to be made somewhat more elastic.

One size fits none

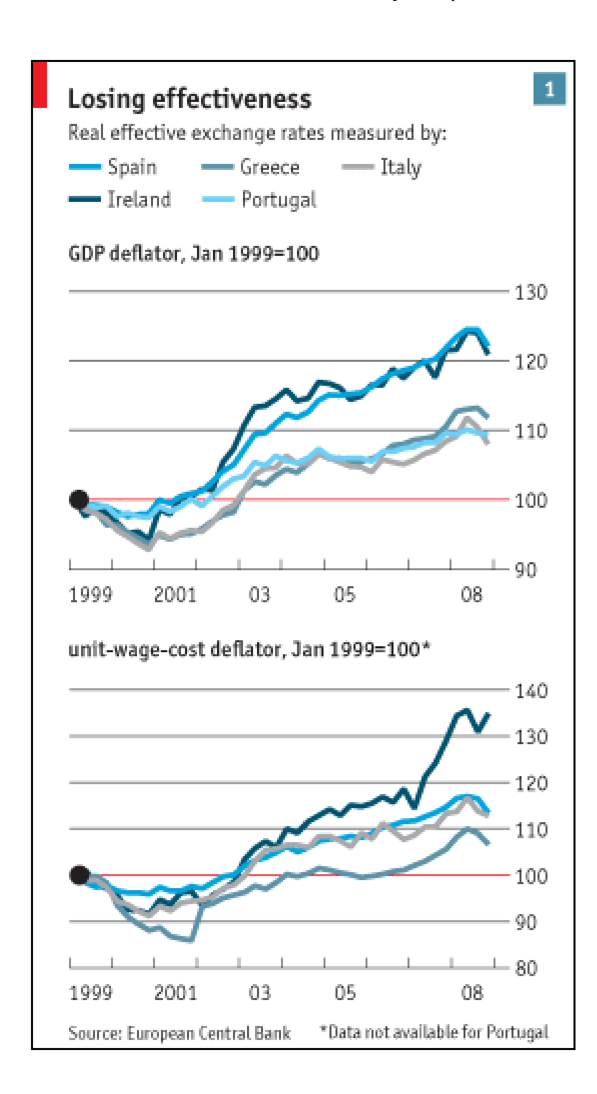
Jun 11th 2009
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The euro did not cause all the euro area's troubles, but it will make them harder to put right

TALK of economic hardship seems out of place on a sunny April day in Barcelona, one of Spain's most prosperous cities. Yet for all the bustle along the Rambla de Catalunya, the city's main drag, the restaurants and cafés are not as full as you might expect at the start of the Easter break. Jordi Galí, an economist at the nearby Universitat Pompeu Fabra (UPF), gives a decidedly unsunny assessment of the task facing Spain.

The country is enduring a painful housing bust that has led to a collapse in the construction industry, doubling the unemployment rate to 18.1% in little more than a year. Recovery seems a distant prospect, not least because during Spain's long boom production costs rose far faster than they did across the euro area as a whole. If left unchecked, higher costs will make it hard for exporters to compete with firms from other euro-zone countries, which account for most of Spain's foreign trade.

Locked into the single currency, Spain can no longer regain its lost competitiveness by cutting its exchange rate. Mr Galí frets that this may condemn the country to a protracted slump. "The discipline of living without devaluation is tough," he says. "It's like enrolling your child in a demanding school. Results may improve, but there's also a risk the child will rebel and fail if you push too hard."

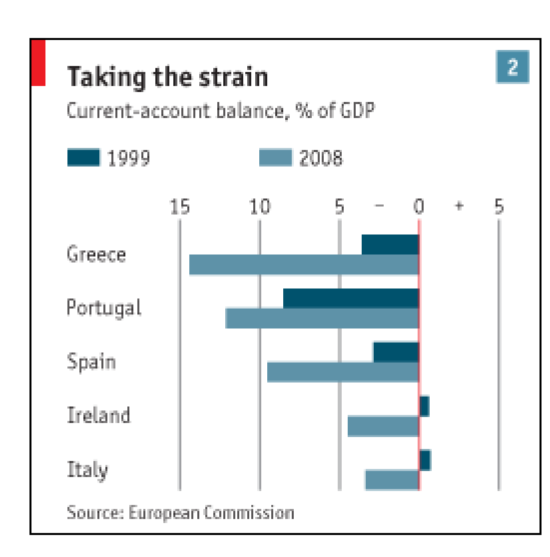


Defiance will be all the greater after a long period of relative ease. For most of the euro's first decade Spain was a star pupil. Its economy grew at an average annual rate of 3.9% between 1999 and 2007, almost twice the euro-zone average and much faster than in any of the currency area's other big countries, France,

Germany and Italy. Unemployment fell from close to 20% in the mid-1990s to just 7.9% in 2007. Even that startling drop does not do justice to the pace of job creation. Employment rose at an average annual rate of 2.8% between 1997 and 2007. The boom in housebuilding lured in migrant workers, many from Africa. The proportion of women at work increased from 38.5% in 1999 to 54.7% in 2007.

Now the legacy of that long boom threatens to deliver a long slump. Of the 11 countries that adopted the euro in 1999, Spain has seen the fastest rise in output prices. Its real effective exchange rate, which measures the rise in domestic prices compared with those in 36 countries weighted by their trade with Spain, rose by around a fifth in the decade after the euro's launch (see chart 1, top). Competitiveness gauges such as these are notoriously sensitive to the price measure used, but on another indicator, based on relative unit wage costs, the erosion of Spain's cost edge is almost as marked (see chart 1, bottom).

Both gauges point up problems in the same handful of countries: Portugal, Ireland, Italy, Greece and Spain—a group given the ugly acronym PIIGS. All five have seen a sharp deterioration in their current-account balances since the start of EMU (see chart 2). Those shifts testify to unsustainable booms in domestic demand, but also signal that local firms have found it hard to compete with imports at home and to sell their wares abroad. Pay rises ran well ahead of efficiency gains in all these countries. In Ireland and Greece gains in output per worker were healthy but wage inflation was high. In Portugal and Spain inflation was a little lower but still well above the euro-area norm. The bigger issue was dismal productivity growth, which was Italy's main problem too.



Swines with flu

All these countries suffer not only from a lack of competitiveness but from other, perhaps more damaging, disorders too. Heavy public-debt burdens and chronic deficits were a feature in Greece and Italy long before the current crisis. Ireland and Spain enjoyed house-price and construction booms that have now turned to busts. In Ireland propping up ailing banks that had lent too freely to property developers and homebuyers, at home and abroad, has bumped up the fiscal cost of recession. (Luckily for Spain, its regulators forced commercial banks to behave more prudently in the boom.) A steady accumulation of current-account deficits has left Greece, Portugal and Spain with net foreign debts of 80-100% of their GDP. These frailties are a threat to the stability of the euro area as a whole.

How much of these imbalances are due to the euro itself? The ECB, a fledgling institution, has managed to keep a lid on inflation: in the euro's first decade consumer prices across the currency zone rose at an average of only 2.1% a year. But in such a large and diverse economy price pressures naturally vary. Capping inflation in fast-growing hotspots, such as Greece and Spain, would have needed a far tighter monetary policy than in the cooler northern climes. Interest rates that seemed right for the whole euro area were too high for sluggish Germany and too low for friskier Greece, Ireland and Spain.

The ECB's one-size-fits-all monetary policy can never be perfectly tailored for any individual member country. In principle, higher inflation should act as a coolant to overheating economies by reducing real household incomes and by making firms less competitive, reducing the incentive to invest. In practice, strong real growth and high inflation are a draw to foreign capital, adding more fuel to the fire. For the same exchange-rate risk, a euro put to work in Spain might earn a better return than in slower-growing parts of the euro zone.

The main hazard for investors in high-inflation countries—that a steady loss of domestic purchasing power will drag the currency down—is eliminated in a fixed-exchange-rate zone. The removal of currency risk from within the euro area helps explain why some countries were able to run eye-watering current-account deficits. In 2007 both Spain and Portugal had deficits close to 10% of GDP. Greece's was 13%. In its absolute size, Spain's deficit was second only to America's.

Foreign capital kept booms going for longer, but that was true in many rich countries outside the euro zone as well. There were other factors at play. The euro was created at a point when the Great Moderation, a long period of stable growth and low inflation in rich countries, was in full train. Investors had come to believe that wild swings in the business cycle were a thing of the past, making them all too willing to take

on risk, including loans to countries that already had large foreign debts. Exchange rates often provide useful warnings about emerging imbalances, but overconfidence and herd behaviour weakened the signal.

Even if the first wave of currency union had excluded Spain and Greece, as some German policymakers had wanted, their economies might still have sucked in foreign capital. The eight eastern European countries that joined the EU from 2004 attracted huge sums of foreign capital even though for many of them euro membership was a distant prospect. This suggests that, even outside the euro, Spain and Greece would have had access to plenty of foreign credit with which to feed a domestic spending boom.

Ireland and Spain were ripe for housing booms too. Both countries have a high rate of owner-occupancy and space for fresh construction. The obsession with housing spilled over from Britain, a serial miscreant when it comes to house-price booms. When Spain and Ireland adopted the euro, they imported low interest rates from Germany: the ECB was the Bundesbank writ large. By then Britain had already adopted the German model of a central bank free from political influence and determined to fight inflation. The results, inside and outside the euro zone, were much the same: lower interest rates that sent house prices mad. Britain, at least, was able to tailor its interest rates to local conditions, but not by enough to prevent a housing bubble.

If euro membership is only partly responsible for the overheating in Ireland, Greece, Portugal and Spain (sluggish Italy can only dream of such excesses), it will make it harder for these countries to deal with the resulting loss of competitiveness. Spain's unemployment rate is already the highest in the euro area and likely to rise further. If Spain's jobless rate sticks at 20%, will voters blame the euro?

A handy scapegoat

"No one sold the euro as a solution to high unemployment," says Mr Galí. But, he adds, the economy used to benefit when market pressures forced down the local currency: "In 1992 and 1993 a series of devaluations got us out of trouble." Now Spain needs other adjustment mechanisms: lower wages to restore cost competitiveness to its firms and a flexible job market to speed the flow of workers from industries such as construction, which catered to a boom fired by domestic demand, to export firms that can generate the revenues to service Spain's debts.

That transition would be hard enough in the best of circumstances. Spain has one of the most rigid job markets in the developed world. Many jobs are heavily protected and wages are set centrally. That will make adjustment all the more difficult. The fear is that Spain will stagnate even as other economies start to revive. "My nightmare is that the world economy, including Europe, recovers and Spain does not manage to hook up to that," says Andreu Mas-Colell, another economist at UPF. "That would be a disaster. It would strain the link between Spain and the rest of the EU. We will also have to deal with tighter monetary policy if the rest of the euro area picks up, creating more pressure."

That fear of being left behind is widely shared in other countries too. Some economists believe that countries now stuck in a slump and unable to adjust their production costs may well start questioning the benefits of euro membership. But where is the exit sign?

No exit

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Staying in the euro will be tough for some members, but leaving would be too awful to contemplate

Illustration by M. Morgenstern



IN THE weeks following the collapse of Lehman Brothers last September the number of euro banknotes in circulation suddenly increased. Fears about the rickety state of banks had made many people mistrustful of keeping money on deposit. Far safer to keep cash stuffed under a mattress. The more discriminating hoarders, it was said, were careful to squirrel away banknotes with serial numbers prefixed by the letter "X", indicating currency issued in Germany. Notes with "U" (French) or "P" (Dutch) prefix were also fine, but those with a "Y" or an "S", issued by Greece and Italy, were shunned.

The logic was that if you were preparing for financial apocalypse, you had better not rely on the euro area surviving intact. In fact, banknotes are a shared obligation of all euro-zone members, no matter where they are printed. If the issuing country were to leave the single currency, a five-euro note would still be worth five euros, whatever the serial number. However, interest-bearing debt denominated in euros is a different matter, and bond markets quickly started to sort the Xs from the Ys.

By early 2009 the yield on a ten-year Greek government bond was almost twice that on a comparable German Bund. The spread over Bunds for Italian, Spanish and Irish bonds also widened dramatically before narrowing again more recently. One explanation was that in skittish markets Bunds were prized for their extra liquidity. Another was that the bond-trading arms of bombed-out banks were less willing to make markets in the issues of small countries, such as Greece and Ireland, which left their prices unmoored.

But at least part of the rise in spreads reflected concern that countries might find it hard to pay back their borrowings. The government bonds of Greece, Ireland, Portugal and Spain were all downgraded a notch by credit-rating agencies. For some, bond spreads are a crude gauge of the risk that the euro will break up. If a euro-zone member were shut out of capital markets and had to default on its debt, it might be tempted to use the opportunity to recreate its own currency and devalue. In that event, creditors could be forced to convert their bonds into claims in a new currency at a discount linked to a new exchange rate against the euro. Default would be one way for countries to free themselves from the euro's shackles—or, to look at it from the opposite point of view, for the euro zone to rid itself of troublesome members.

A game of consequences

That kind of thinking, however, is found mostly among those who were doubtful that the euro would ever get off the ground in the first place. It is rare in countries seen as candidates for exit. As Eurocrats in Brussels are keen to stress, far from breaking up, the euro zone is growing. Since its launch it has taken on five new members, and more are queuing to join.

The costs of backing out of the euro are hard to calculate but would certainly be heavy. The mere whiff of devaluation would cause a bank run: people would scramble to deposit their euros with foreign banks to avoid forced conversion to the new, weaker currency. Bondholders would shun the debt of the departing country, and funding of budget deficits and maturing debt would be suspended.

Changing all contracts in euros—bonds, mortgages, bank deposits, wage deals and so on—to the new currency would be a logistical nightmare. The changeover to the euro was planned in detail and the exchange rate was fixed in advance, in co-operation with all the euro members. The reverse operation would be nothing like as orderly, not least because the exchange rate would be a moving target.

If businesses converted their debts to a weaker currency, that might constitute default and trigger legal challenges. If they stuck to their covenants, they would have to service their euro debts from earnings in a weaker currency. That would hurt firms which rely mostly on profits from their domestic market. The convulsions would be felt by other euro-area members too. The writedown of the departing country's government bonds might threaten the solvency of banks in the rest of the euro zone. Around half of Italian government bonds, for instance, are held outside Italy. Other euro-area members could suffer contagion as markets bet on further defaults.

If the act of leaving would be hard, the aftermath might be even harder. A country that forced bondholders to take a loss would be punished. Continued access to bond markets would come at a high price. Investors would ask for a huge premium to cover the risk of further default. On that count alone, borrowing costs would be far higher than they were within the safer confines of the euro area.

Investors would have to protect themselves from two further risks: exchange-rate volatility and inflation. A former euro member would have to reinvent its own monetary policy and would struggle to convince investors that it could keep a lid on inflation. One of the euro's big attractions was that it offered many countries a shortcut to a credible monetary set-up. Devaluation could itself trigger a wage-price spiral. For high-debt countries, such as Greece and Italy, the interest rates demanded by markets to insure themselves against such risks would be ruinous.

And even though the costs are likely to be heavy, the immediate benefits might prove only transitory. A devaluation is a proxy for a national pay cut: it helps exporters but makes consumers of imports poorer. Workforces would put up strong resistance to being paid in a weaker currency. In countries such as Greece and Ireland, whose exports contain a lot of imports, a devaluation would push up inflation. And where a large proportion of wage contracts is indexed to prices, as in Spain, higher inflation would rapidly work its way through to wages.

The wrong cure

An exit from the euro would not tackle weak productivity growth and inflexible wages, which are the root causes of low competitiveness. In time, further devaluations might be needed. Countries with high debts and a history of poor macroeconomic management would be most tempted to leave. But these are also the countries most likely to be hurt.

A more plausible, though still unlikely, scenario would involve a breakaway by a group of low-debt and cost-competitive countries, centred around Germany. Members of a new, "hard" European currency would leave behind a stock of depreciating euro debt and might be rewarded by lower borrowing costs on debt issues in the new currency. Yet a large part of the appeal to Germany of the single currency has been that it rules out revaluations and rewards its firms for being competitive. Germany, France and the rest have too much invested in the success of the EU and the euro to put it at risk. As Daniel Gros of the Centre for European Policy Studies, a Brussels think-tank, puts it: "The weak can't leave and the strong won't leave."

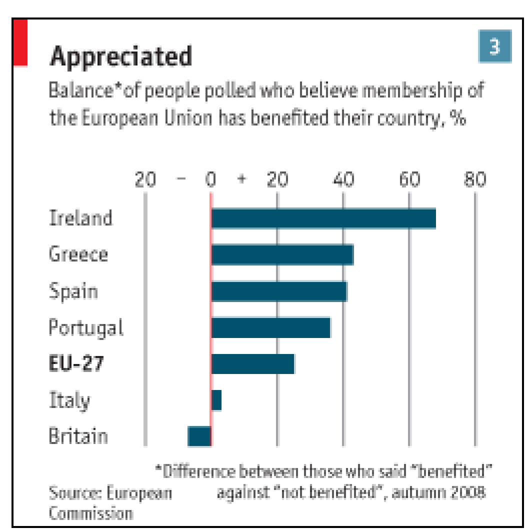
The non-nuclear options

Jun 11th 2009
From The Economist print edition

In place of devaluation, troubled members could try reform

SPAIN may soon be faced with two options, says UPF's Mr Mas-Colell: a permanent slump or economic reform. "A third option, exit from the euro, is not a possibility. Spain won't leave because it is very pro-Europe. To leave would be seen as a national failure rather than a liberation." Euro membership is a symbol of Spain's progress as a democracy as well as its economic development. For some, it is an insurance against a return to dictatorship and autarky. "Our experience is that when we went for being more European, the results were positive," says Elena Pisonero, a former vice-minister for commerce, now at the Madrid office of KPMG, a consultancy. "In the past [during the dictatorship of Francisco Franco, which ended in 1975] we were closed off. Opening up our borders brought huge benefits."

Ireland, like Spain, has been helped by EU funds for roads, farming and universities. According to the most recent Eurobarometer, a twice-yearly opinion poll, 79% of respondents in Ireland believe that overall their country has benefited from EU membership, and only 11% think it has not. The positive response in Greece, Spain and Portugal was above the average for all EU countries (see chart 3).



Most Greeks are in favour of the euro, and only 12% think EU membership is bad for their country. That is poor ground on which to build a case for quitting the euro. Greece's finance minister, Yannis Papathanassiou, thinks that the recent spike in Greece's borrowing costs was driven by the mistaken belief that last December's violent street protests were due to a faltering economy. In fact the demonstrations were sparked by the killing of a 15-year-old boy in Athens by a policeman. Some people had taken rising bond spreads as an omen of default and euro break-up. That prospect, always distant, has now receded further. "Despite the high spreads, we have shown that we can refinance our debt," says Mr Papathanassiou.

Italy's economic travails have attracted less attention recently. Unlike Greece, Ireland and Spain, whose economies grew rapidly before crisis struck, Italy has seen its GDP growth drift consistently below the euro-zone average (see chart 4). Its cost-competitiveness has declined and its public debt was already 106% of GDP last year and will now rise still further. Yet in March, when the strains in the euro area's public-debt markets were at their greatest, Italy's ten-year bond yields were around 1.5 percentage points above Germany's, compared with a gap of 2.8 percentage points for Greece.

Where it hurts 4
GDP, % change on year earlier
1999-07* 2008 2009†
10 5 – 0 + 5 10
Ireland
Greece
Spain
Euro area
Italy
Source: European Commission
*Average annual rate
†Forecast

Nor was Italy's public debt downgraded. "Perhaps the credit-rating agencies are being responsible," an Italian economist suggests by way of explanation. If Italy did get into funding trouble, that would have repercussions for the rest of the euro zone. Its public debt dwarfs that of countries the size of Ireland or Greece.

If the rating agencies have been careful not to sound the alarm, the same is true of Italy's politicians. In the past Silvio Berlusconi, the prime minister, and Giulio Tremonti, the finance minister, have been quick to blame the euro and the ECB for Italy's economic problems. Bashing the euro was a useful way of attacking Romano Prodi, a centre-left opponent, who in his first stint as prime minister, in the late 1990s, took Italy into the euro before becoming president of the European Commission. The rhetoric has noticeably softened. Earlier this year Mr Tremonti described the euro zone as "totally sustainable". The currency crises in Hungary and Iceland were

salutary, says Roberto Perotti of Milan's Bocconi University. "No serious politician now says 'let's leave'."

Devaluation by proxy

Is there a way of achieving the effects of a fall in the real exchange rate without going to the extremes of ditching the euro? As long as it does not trigger a burst of wage inflation, a devaluation lowers wage costs relative to those of workers abroad, improving the competitiveness of firms producing things that can be traded across borders. A weaker currency also shifts the balance of demand by making imported consumer goods dearer and exports cheaper. That cools spending at home and tilts the scales towards firms that sell abroad, nudging workers and capital in their direction.

Illustration by M. Morgenstern

In a currency union, pay needs to adjust that much more quickly to changing market conditions to shift workers out of high-cost industries. But until quite recently pay has tended to be "sticky" on the way down: workers have generally been reluctant to take wage cuts, at least in nominal terms, which has made real-wage adjustment slow. On many reckonings, the rate at which Germany went into the euro in 1999 was too high. The traded value of the Deutschmark had not fallen to reflect the higher unit wage costs that were a legacy of the unification boom. It took many years of very low wage growth and rising productivity before Germany regained its edge on costs.

That route to redemption has become even harder for today's high-cost countries because there is little consumer-price inflation around to erode real wages and rebuild profit margins. Unemployment seems likely to rise steeply before wages start to adjust.

Ireland will make the adjustment more quickly than the others. Already there are signs that private-sector wages are falling in response to rapidly rising unemployment. The 7.5% cut in public-sector pay that came into force in May was mostly a response to the fiscal crisis, but was also sold as a remedy for lost competitiveness. Ireland is set to endure a deeper recession than other rich countries because of its "globalised" economic model. But because of that sensitivity to the world business cycle and its reliance on big multinational firms for investment, wages are unlikely to stay out of whack for too long.

In the Mediterranean economies the pressure on wages is mostly in the wrong direction. In Spain most private-sector pay deals contain clauses that compensate employees if inflation is stronger than expected. The country also has a managed system of wage-setting that fails to make enough allowance for different productivity levels across the economy.

Wages in Italy are set centrally too (as they are in Greece), although compensation for inflation is no longer automatic. The infamous *scala mobile*, which maintained a rigid link between Italian wages and prices, was scrapped in 1992 after a long struggle.

Here today, gone tomorrow

The spread of fixed-term employment contracts in Spain (from the mid-1980s) and Italy (in the mid-1990s) helped make hiring and firing more responsive to the business cycle. The innovation had an immediate pay-off: it created jobs. Firms were content to take on temporary workers, often immigrants, because they knew they could easily lay them off again. Before the crisis hit, temporary jobs accounted for more than a third of Spain's total, the largest share in the EU. Tito Boeri of Bocconi University reckons that a fifth of Italy's workforce are on (short) fixed-term contracts. The rest enjoy a high level of job protection which politicians dare not dismantle. Both countries saw temporary contracts as the only way to free the jobs market.

Jobs that were created in good times are now being shed quickly. The downturn has highlighted the gross unfairness of the dual labour market. It puts the burden of adjustment on groups with no tenure (women, immigrants and the young). Protected workers, the bulk of the workforce, cling to their jobs. That tends to fossilise the structure of the economy. Old industries, where productivity is waning, are slow to die and new firms slow to start up.

The growth of temporary contracts hurts productivity in another way. Firms are obliged to lay off (typically young) contract workers at the end of a fixed period, so they have little incentive to train tomorrow's workforce. Instead they are stuck with older, tenured workers heading for retirement. The result in Italy, says Mr Boeri, is a "lost generation" of workers with limited skills. Admittedly the growth in temporary contracts has helped many people back into work and has lowered long-term unemployment. But the evidence from Spain suggests that such contracts are rarely a bridge to better things: less than 5% are converted into permanent jobs.

A group of economists led by Samuel Bentolila of CEMFI, a graduate school in Madrid, have set out a reform manifesto for Spain's jobs market. They suggest that wage-setting could be made more flexible if deals struck at the level of individual firms were allowed to prevail over regional or industry agreements. They also propose replacing fixed-term contracts for new hires with a permanent contract in which firing costs rise with seniority but not as high as at present.

Mr Boeri and his colleagues have called for a similar scheme in Italy, where workers build up employment rights over time. Abolishing job protection makes most workers worse off, so it tends to run into political obstacles. The next best thing is gradually to reduce average firing costs and giving firms better incentives to train their workers. If Italy wants to encourage workers to risk moving jobs, it also needs to beef up its skimpy unemployment benefits. "Italy should say to its partners: 'our fiscal stimulus is to introduce a welfare safety net to speed up the reallocation of jobs'," says Mr Boeri.

Never a good time for reforms

Such reforms would be desirable even if nobody had signed up to the euro. When the currency was created, the hope was that the loss of the safety valve of devaluation would help to boost productivity and make markets more flexible. For most of its first decade timid politicians were able to shelter behind the economic stability that the euro helped provide. Without a crisis it is hard to persuade voters of the need for radical change. Yet recession is the worst time to make changes that leave some groups poorer.

Italy's previous big recession, in 1992-93, prompted a wave of reforms: privatisations, changes to pension entitlements, the creation of a competition authority and the demise of the *scala mobile*. Greece is now inching ahead with some reforms along similar lines. The government has sold Olympic Airways, a subsidy-thirsty airline, and a competition law is going through parliament that will give antitrust authorities more power to challenge—and break up—big companies that can set prices. In Spain one relatively painless reform would be to change the rules for renting out property, which currently overprotect tenants. If owners felt more relaxed about letting out second homes, workers might find it easier to move in search of jobs. It might even lift house prices.

For now, policymakers are too worried about fragile demand to risk tackling the supply side of the economy. Today's economic crisis has little to do with differential wage costs within the euro. In terms of relative unit wage costs, Germany's competitiveness has improved by around 13% since the euro started. Yet this year the German economy is set to shrink by more than any other in the euro area bar Ireland because of its heavy reliance on exports. Greece is expected to hold up better because it is less exposed to the global economy ("a good thing for a bad reason," notes one policymaker). Its GDP is likely to fall by around 1%, making it one of the most resilient economies of the OECD's 30 members. Italy's economy will do far worse, but there is less of a sense of crisis because it has long been struggling anyway.

Root-and-branch structural reform will have to wait a while longer. Germany's travails are not a good advertisement for maximising competitiveness. Only in Ireland, where the economic model is based on openness to trade and foreign investment, is competitiveness a big part of the policy debate. Elsewhere politicians seem somewhat stuck. "At some point we'll have to accept that it's better to have people in work than to have high wages," says Mr Mas-Colell. "In Spain we are not ready for that. There is an illusion, a hope, that we will wake up tomorrow and things will be better."

Yet all the current troubles of the hardest-hit euro-zone countries do not seem to have put off a raft of applicants, mostly in eastern Europe, from trying to join the club. Indeed, if anything, the financial crisis has made many countries even keener to join. Do they know what they are doing?

Fear of floating

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The financial crisis has made the euro look more alluring


Illustration by M. Morgenstern

IN 1999, the year the euro was launched, the Nobel prize for economics was awarded to Robert Mundell, a Canadian economist. That was good timing because his work was influential in shaping the euro zone. In a 1961 paper Mr Mundell had pioneered the theory of an "optimal currency area", a territory suited to adopting a common monetary policy. A main requirement, he concluded, was that workers throughout such an area would be sufficiently inclined to move jobs to even out regional booms and slumps. In later research others added strong trade links, wage flexibility and a central fiscal authority to the list of necessary features.

Equally important to the decision to join a monetary union was another of Mundell's insights, developed with Marcus Fleming at the International Monetary Fund, which entered the economics textbooks. This was the idea of the "impossible trinity": that a country could not simultaneously have a fixed exchange rate, be open to capital flows and operate an independent monetary policy. It could opt for any two of these features but not all three together. With free capital flows, monetary policy could be directed either at stabilising an exchange rate or controlling inflation, but not both. A country that targets domestic inflation and is open to foreign capital must have a flexible exchange rate.

When Mr Mundell expounded his theory, in the early 1960s, most rich countries were tied to the Bretton Woods system of fixed exchange rates. Because capital flows were tightly controlled, countries could set their own interest-rate policies and still keep exchange rates more or less fixed against the American dollar.

Canada was different. Its long border, heavy trade and strong industry links with America made capital controls impractical. For Canada to have an independent monetary policy, it had to let its currency float. In later writings Mr Mundell expressed regret about Canada's choice, as well as enthusiasm for European monetary union. In principle, a currency adjusts to keep economies in balance, but in practice, argued Mr Mundell, exchange rates veer wildly from their ideal levels. Large and volatile capital flows mean that floating currencies can be a source of instability. They are also a poor substitute for fully flexible wages and prices.

In or out?

The merits of monetary flexibility versus exchange-rate stability have to be weighed up by the 11 EU countries that are not (yet) in the euro. The choice is straightforward for Britain, which has long been reluctant to give up its independent monetary policy and has an opt-out from the euro. Britain's policy brass tend to see a flexible exchange rate as a useful safety valve. Sweden, like Britain, does not seem to have much to gain from hitching itself to the ECB. It has built a credible monetary regime, with an independent central bank, along similar lines. Since a referendum in 2003 that came out against membership, Sweden has shown no interest in getting closer to the euro club.

Denmark's currency is pegged to the euro but the country remains outside the euro zone after twice failing to secure a popular vote in favour of joining. It has the worst of all worlds. The currency peg is open to speculative attack, so its exchange-rate stability is precarious; yet to preserve it, the country has had to sacrifice an independent monetary policy. The government has been mulling a third referendum but the new prime minister, Lars Lokke Rasmussen, said in April that it would not take place this year.

The other eight potential members are former planned economies in central and eastern Europe (CEE) that joined the EU on or after May 2004. All are keen to adopt the euro. Those that had been cool on

membership, such as the Czech Republic, have warmed up since last autumn's financial turmoil. Most are small and very open economies whose exports account for a large share of GDP and whose trade ties to the euro area are strong. As emerging economies they are prone to sudden shifts in foreign-investor sentiment, which makes for volatile currencies, so exchange-rate stability holds considerable appeal for them. None of them has a long record of stable money, so loss of monetary independence would not be greatly mourned. For four of the eight the euro is already their monetary anchor. The three Baltic countries, Estonia, Latvia and Lithuania, have long pegged their currencies to the euro, and before that to the D-mark. Bulgaria also has a euro peg.

For small, open economies such as those of the Baltic states (and Iceland, which now plans to join the EU as a stepping stone to adopting the euro), it makes sense to tie currencies to a big and stable neighbour. Even Milton Friedman, a fervent advocate of floating exchange rates, thought so. In the Baltics, Latvia's euro ambitions are on hold. Following a bail-out led by the IMF in December, its economy and public finances are in intensive care. Estonia wants to join quickly and may do so as soon as 2011. A realistic target for Lithuania is 2012.

For a larger country, such as Britain, the benefits of membership are less obvious. A bigger portion of the goods and services it consumes is produced at home, so there is more scope to manage domestic prices through an independent monetary policy.

The outsiders 5

	% of GDP 2009					
	Budget balance	Public debt	GDP at market prices, €bn, 2008	Exports, % of GDP, 2007	Consumer prices*	10-year gov't bond yield, %†
Euro area	-5.3	77.7	9,209	41.6	2.7	3.69
Britain	-11.5	68.4	1,812	26.4	3.7	4.11
Bulgaria	-0.5	16.0	34	63.4	10.1	7.04‡
Czech Republic	-4.3	33.7	149	80.2	4.7	4.65
Denmark	-1.5	32.5	233	52.3	3.2	4.10
Estonia	-3.0	6.8	16	74.4	8.6	na
Hungary	-3.4	80.8	105	80.3	5.0	9.40
Latvia	-11.1	34.1	23	42.2	13.4	7.90
Lithuania	-5.4	22.6	32	54.4	10.5	7.89§
Poland	-6.6	53.6	362	40.8	4.0	6.02
Romania	-5.1	18.2	137	29.5	7.6	8.95
Sweden	-2.6	44.0	328	52.6	3.1	3.49

Sources: European Commission; Thomson Datastream; Bloomberg

*% increase on a year earlier, latest 12-month average †Latest 12-month average ‡Latest 5-month average §8-year gov't bond

Poland could fit that bill too. It is the largest and one of the least open of the CEE8 (see table 5). Though not nearly as rich as Sweden in terms of income per head, it has many more people, so its economy is bigger. Its exports account for two-fifths of GDP. Because its exposure to world trade is smaller than that of many other EU countries, it has suffered far less from the global recession. The European Commission reckons its economy will shrink by 1.4% this year, which is not a lot by the dismal standards of the region.

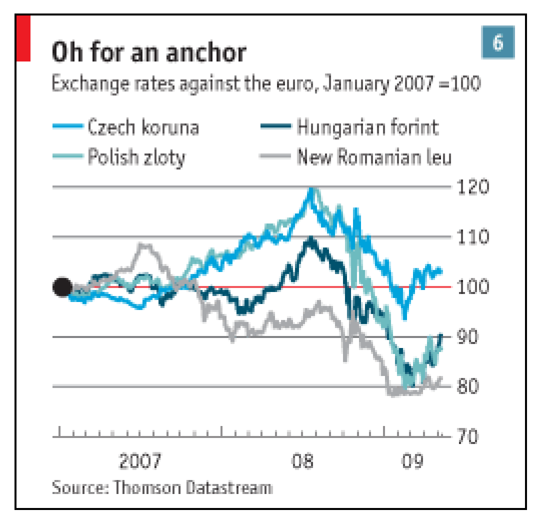
The case for a quick dash

Despite the size and resilience of Poland's economy, its government wants to get into the euro as soon as possible. It hopes to join the ERM-2 (a pledge to keep the exchange rate within agreed bounds for two years) early next year in order to qualify for euro membership by 2012. As elsewhere in the region, part of the rush to qualify is to forestall a further drop in the zloty, which would make foreign-currency loans harder to pay off. Around 30% of private-sector debt is in foreign currency, far less than in Hungary but more than enough to hurt the economy if the zloty sinks. Hopes of entry in 2012 may be optimistic, and some economists question the wisdom of forcing the pace. As a fast-changing economy Poland might need the flexibility of a floating exchange rate for a little longer to keep it competitive and to smooth adjustments.

But can it rely on the right kind of help from currency markets? Recent experience suggests that there is no stable link between the economy's vital signs and shifts in its currency. For a while the exchange rate had

been a balm. Between 2005 and 2007 the zloty's value increased in line with productivity (as a country becomes richer, its currency tends to rise in real terms). That helped to keep inflation low without harming exports.

The benign period ended in the autumn of 2007. The zloty, and some other eastern European currencies, were driven up (see chart 6) as investors piled into emerging markets in the belief that they would soon "decouple" from troubled rich-world economies. A year later, following the collapse of Lehman Brothers, the markets made a U-turn. Capital flooded out of eastern Europe, starving the region of foreign currency and plunging it into a severe crisis.



When a floating exchange rate proves to be an irritant rather than an emollient, fixing it once and for all has greater appeal. Most of Poland's trade is with the euro area and much of that is intra-firm trade: between, say, a German firm and its Polish subsidiary. Adopting the euro should open Poland up to more of that sort of trade and the stable, long-term capital investment that goes with it. And once currency risk vanishes, government, firms and households will all be able to borrow more cheaply—and, as important, given the recent freeze-outs—more easily.

In purgatory

The financial crisis may have increased the allure of the euro zone, but it has also made it trickier to get in. To join, countries must first meet the "convergence criteria": targets for inflation and public finances, as well as market-based tests for low long-term interest rates and a stable exchange rate (ie, two years in ERM-2). Slovakia made the cut when the criteria were last assessed, in May 2008, and joined in January. Of the eight CEE countries still outside, all bar Poland and the Czech Republic missed the mark on inflation, which was supposed to be no more than 1.5 percentage points above the average of the three EU countries with the lowest rate. Poland, for its part, failed to qualify because of doubts that it could control its budget deficit and worries that it owed its low inflation to the rise in the zloty (which was not in ERM-2).

With economies facing a deep recession, inflation is set to drop sharply (though the benchmark for the test is falling too). The public-finance criteria will be far harder to meet. Euro aspirants must show that they can keep their budget deficits below 3% of GDP and cap their debt ratio at 60%. That is tough in a downturn: most countries inside the euro area are already in breach of these rules. But hopes that the rules might be relaxed have been dashed. Those inside the euro fear that easing up on potential entrants would undermine the single currency. There may be a feeling that "we had to suffer to get in; so should you." Some outside the ark are also against a free-for-all. The stronger aspirants, Poland and the Czech Republic, have distanced themselves from calls by troubled Hungary (like Latvia, an IMF supplicant) to shorten the qualifying period in ERM-2 from two years.

Would fast-track entry really harm the euro? The worry that euro-zone countries such as Spain may suffer prolonged slumps because they lost control of unit wage costs lends the inflation test some weight, though not much. Willem Buiter at the London School of Economics is not convinced. He thinks that inflation convergence is something to be expected after adopting the euro, not before. Getting rid of anything that may give rise to inflation is in the self-interest of new joiners. So is fiscal discipline. But insisting on them prior to entry amounts to "misplaced paternalism", according to Mr Buiter. "If you have time to get inflation down, fine. But floating exchange rates are dangerous. The main thing is to get in."

On one count, the would-be entrants are more flexible than the incumbents. Migrants from Poland and other eastern European countries have shown themselves willing to move in search of work. Lessons can also be learnt from the mistakes of others. Andrzej Slawinski, a member of the Polish central bank's monetary-policy council, believes there is less of a risk that the new member states will follow in the footsteps of Greece, Ireland, Portugal and Spain. They are still poor by EU standards, so can look forward to a period of fast productivity growth. Were unit wage costs to rise too far, they could recover competitiveness more quickly.

Poland may be able to guard against the risk of credit and housing booms because the climate now favours tighter bank regulation. "Banking supervisors must have the authority to react to the business cycle in a

dynamic way," says Mr Slawinski. Governments must also be careful not to fuel housing booms with tax breaks. Instead property taxes could be used to cool overheated housing markets.

Once Poland and the smaller CEE countries adopt the euro, might Britain's attitude change? If Denmark were to join too, the euro area would cover almost all of the EU's member states, so Britain might once again look like the odd one out. Even so, it is likely to draw the same lesson from this crisis as it did from the ERM expulsion in 1992: that devaluation is a good thing. There is chagrin in some European capitals (especially in Dublin) that sterling has dropped so far and fast against the euro. A weaker pound, even with world trade in retreat, still cushions the profit margins of struggling exporters. It will only harden the belief in Britain that currency flexibility should not be lightly given up.

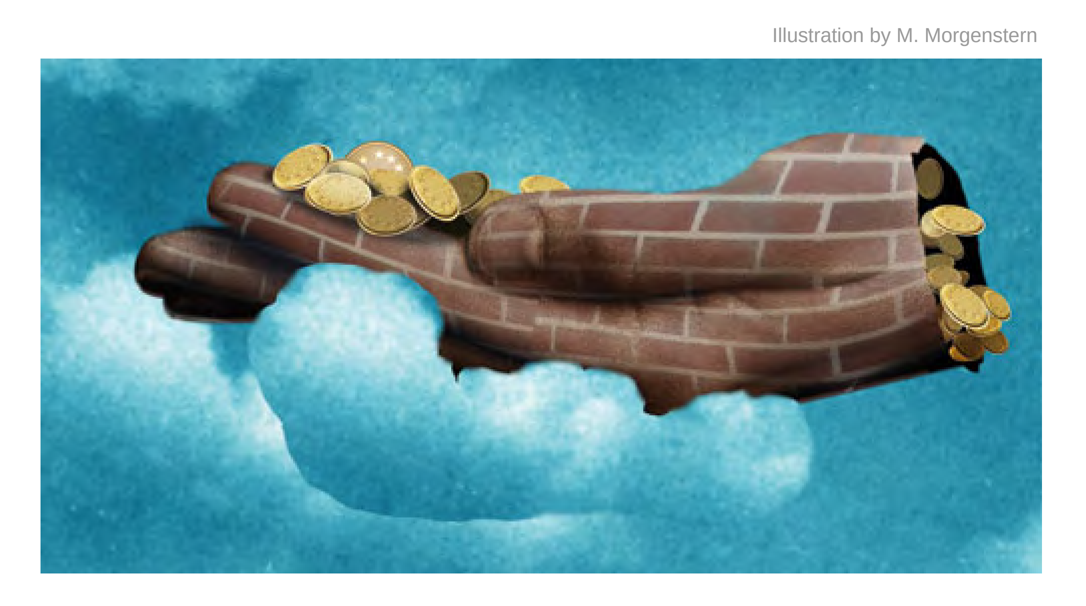
In any case, no British government could now consider signing up to the euro without first winning a referendum, and opinion polls have shown a fairly consistent two-to-one majority against joining the single currency. Even if Britons could be sold on the narrower issue of economic benefit, they are more likely than most Europeans to see national control over monetary policy as indivisible from other kinds of sovereignty. The euro's success so far has suggested that a currency can be stable without the backing of a unitary state. But the financial crisis has raised a fresh question mark over that idea.

Soft centre

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Can a currency survive without a state?

Illustration by M. Morgenstern



LAST November the European Commission set out its proposals for a Europe-wide fiscal stimulus, worth a combined €200 billion, roughly 1.5% of the 27-nation block's combined GDP. The commission has a relatively small budget and no authority to compel member states to shell out extra cash or cut taxes (and, to its regret, little clout to stop them from running up budget deficits). So it had to content itself mainly with a co-ordinating role.

The commission, along with the European Investment Bank, found €30 billion of EU money to contribute towards the €200 billion target, mostly by speeding up spending programmes. Of this, €5 billion was unspent infrastructure money from the EU budget which would normally be returned to the rich member states that had provided it. Three months later governments were still arguing about where or indeed whether this money, a trifling sum in the scheme of things, should be spent. Brussels insiders see this episode as typical of the painfully slow process of putting plans into action. It also illustrated how reluctant governments are to cede control over their own revenues.

There had been hopes that they might become more co-operative. Helmut Kohl, who as German chancellor was one of the midwives of the Maastricht treaty, thought a single currency could not survive without political union; indeed its main appeal was that it would make such union more likely. In November 1991, a month before the Maastricht summit, he told the German parliament that it was a "fallacy" that monetary union could last without political union. By the time the euro was launched in 1999, many people thought that some form of fiscal counterweight to monetary union would soon follow. "You didn't have to be a federalist to believe then that the euro would prompt more political integration," says Jean Pisani-Ferry of Bruegel, a Brussels think-tank.

The belief seemed well founded on several counts. Money is a form of government debt, so a paper currency, it was thought, must need a state behind it. Historical examples of a currency block not backed by a unitary state are rare, and such few as there have been did not last long. According to the theory of optimal currency areas, a central fiscal policy is necessary because a single interest rate will not suit conditions in all parts of a currency zone. Just as welfare spending and revenue raising help to smooth out regional kinks in national business cycles, a "fiscal euro zone" would act as a stabilising force for a shared currency area.

Rules of the game

What institutional structures would be needed for political union was rarely made clear, only that there would soon be more of it. In the meantime a set of fiscal rules—the stability and growth pact, which put a cap on budget deficits and public debt—would take the place of a central system of revenue sharing. Each country would insure itself against a downward lurch in its economy by running a balanced budget or, in good times, a surplus.

These fiscal rules had another purpose, which was often given greater emphasis: to prevent imprudent countries from imposing costs on others. Big deficits in one country might make it harder for others to compete for funds from savers, driving up interest rates for all. If such deficits were to add materially to the average debt burden, investors might fret that governments will attempt either to inflate away their debts or to pass them on to other countries, so will demand higher rates from all borrowers as protection. The EU treaty contains two clauses to try to limit this transfer of costs. The first bars the ECB from creating money to finance deficits. The second forbids countries from assuming the debts of others (the "no bail-out" clause).

The pact did not work well. The emphasis on the costs to others of fiscal indiscipline meant that countries were careful to behave no worse than their peers, rather than trying to be prudent on their own behalf. In good times public finances tended to add to, not subtract from, demand pressures: fiscal policy often worked against the monetary sort rather than complementing it, as the pact intended. The costs of fiscal laxity were low. Before crisis struck, the slack attitude towards credit risk in bond markets meant that borrowing costs for high- and low-debt countries were similar. When in 2003 the European Commission threatened to impose penalties on France and Germany for excessive deficits, the pact was first suspended and then amended, with get-out clauses for "exceptional" events.

Ireland and Spain had complied with the pact in good times, but had relied too heavily on windfall revenues that evaporated along with their housing booms. Ministers had been able to insist that their fiscal policies were sound because they fitted in with the pact's narrow guidelines, says Mr Pisani-Ferry. Since fiscal soundness was central to "stability", they could claim that their overall economic policy was fine too.

Once the crisis had blown up last autumn, the lack of a fiscal centre to the euro zone became a live issue. Initially the euro rallied, but haphazard efforts to shore up banks, and later the economy, undid that early vote of confidence. Scared investors rushed into the safest dollar assets, lured by the liquidity of the vast market for US Treasuries, as the euro area was revealed as a mess of fragmented bond markets. Small euro-area countries with oversized banking industries, such as Ireland and Belgium, found that their bonds were shunned, driving up their borrowing costs relative to Germany's. Markets were becoming increasingly anxious that a euro-zone issuer might run into funding difficulties, since there was no system for countries to help each other out.

The clunky governance of the EU and euro area worked against a rapid response to the crisis. Political power within the EU is dispersed, residing in state capitals rather than in Brussels. There is no powerful executive to take and enforce quick decisions. National interests got in the way of fiscal-stimulus packages and efforts to co-ordinate bank guarantees and rescues. Germany has the deepest pockets, but its instinctive thrift (and the suspicion that the benefits would be felt mostly outside Germany) militated against swift and co-ordinated action. That made it harder for less affluent countries to loosen their purse strings, as they could not risk looking in worse fiscal shape than their peers.

Good old ECB

The one euro-zone institution that could—and did—act decisively was the ECB. But even its ability to tackle slumps is constrained. Were there just one sovereign issuer of euro-zone debt, rather than 16, the ECB could more easily engage in unorthodox policy measures, such as buying up government bonds to drive down long-term interest rates. It would also find it easier to negotiate an indemnity against capital losses on asset purchases.

Despite the crisis, there are few signs of progress towards better fiscal co-ordination. Earlier this year, as bond spreads continued to rise, policymakers dropped heavy hints that struggling sovereign borrowers would not go unaided. Peer Steinbrück, the German finance minister, said in February that if a euro-area country found itself in trouble, "we will show ourselves to be capable of acting." The following month Joaquín Almunia, head of the commission's economics directorate, said that a European "solution" was in place so that any cash-starved country would not have to go to the IMF for an emergency loan. Mr Almunia did not give any details. The German finance ministry later denied that it was working on bail-out scenarios.

The panic revealed another gap in the euro area's fiscal set-up: a process for dealing with a sovereign default, or the threat of one. The larger the number of countries that have adopted the single currency, the more likely it is that one will get into trouble. It would be sensible to have a contingency plan.

One idea is a dedicated bail-out fund for euro-zone members, along the lines of the IMF. This is proposed by Thomas Mayer, an economist at Deutsche Bank, who started his career at the fund in the 1980s. Like the IMF, a European Monetary Fund (EMF) would offer emergency loans for governments unable to finance their budget deficits or roll over maturing debts. In return for this insurance, each member would contribute capital to the fund in proportion to the size of its population or GDP. Loans would come with conditions. A supplicant would have to pledge to put its public finances in order and undertake other economic reforms to persuade bond markets to renew lending.

This sort of proposal attracts two main criticisms. First, it is wasteful to duplicate the efforts of the IMF. Until very recently the fund was struggling to define its role (and raise money) because it had so few lending opportunities. Now it is busy fighting fires again, many of them in eastern Europe, so there is far less talk of staff cuts. But an EMF could stand idle for even longer before it saw action. A second quibble is that a euro fund may find it difficult to impose tough conditions on rescue loans. Better to let the IMF play the role of bad cop, say some, than have protesters burning the EU flag in countries forced to slash public spending or hike taxes.

Mr Mayer retorts that even the IMF has learnt that its interventions work only if countries co-operate. The idea that a financial policeman has to be strict to be effective is dated. He sees a European fund as more than an emergency kitty for cash-starved euro members. It could act as a permanent monitor of economic policies, including government budgets, and issue a seal of approval for countries wishing to take part in a joint bond issue. Over time, the emergency fund could evolve into an institution that improves the euro area's fiscal co-ordination.

The beauty of a euro bond

The hurdle for membership of such a programme would need to be high to persuade countries with good credit, such as Germany, to sign up to it, and to convince credit-rating agencies and investors to rank its bonds highly. But a large collective bond issue could have benefits even for countries with low credit risk, as it would rival America's Treasuries market for liquidity. A single issuer would make euro-area bonds more attractive to managers of foreign-exchange reserves, who want safe stores of value that can be converted into cash quickly and cheaply in an emergency. A joint bond issue could thus enhance the euro's standing as a reserve currency, as well as lowering borrowing costs for all countries that took part in it.

The idea of a shared euro bond has been pushed by Italy's Mr Prodi, George Soros, a veteran investor, and others. That Italy is keen on the idea is hardly surprising: pooling its poor credit ratings with others of higher standing would lower its borrowing costs and reduce the risk, albeit small, that it might have its financing cut off. Germany is understandably cool on the idea. Mr Steinbrück has said that the extra cost to his taxpayers would make it hard to sell politically. Many in Germany feel that even temporary help for cash-strapped partners should be provided by the IMF only, and on strict terms. They resent the fact that Greece and Ireland enjoyed years of prosperity and still found themselves in fiscal trouble. Bail-outs, they feel, only encourage profligacy.

A rescue of one country by its partners could undermine popular support for the euro, says Otmar Issing, the ECB's chief economist for its first eight years, because it would imply a transfer of taxpayers' money without endorsement from the voters in countries that have to pay.

Mr Issing, who had previously sat on the Bundesbank's rate-setting council, once believed that the euro needed more political union to thrive, but has modified his views. Political union, he now thinks, may even work against monetary union if it is founded on a model that would make economies more rigid. EU policies, once in place, are hard to reverse even if they are clearly harmful, as decades of farm subsidies have shown. The euro has little bearing on ambitions for a common foreign or defence policy.

The euro's short history suggests that a successful monetary union does not necessarily need deeper political integration. True, by American standards the euro area's response to the crisis was slow and lacked co-ordination. But that is part of the price countries pay (and consider worth paying) for retaining full fiscal sovereignty. In any case, since welfare benefits are more generous and taxes heavier in Europe than in America, automatic fiscal stabilisers are more powerful in the old continent. A measure of co-ordination is

already built into the euro area's fiscal policy.

The stability and growth pact is now too full of holes to be a binding constraint on fiscal policy. In an important sense it was always redundant. If monetary financing is banned and the "no bail-out" commitment is real, then fiscal discipline is largely an issue for individual countries. If they let finances slip, bond markets will exact a penalty in higher borrowing costs, as they have done in recent months.

There are nevertheless a few minimum requirements for a fiscal euro zone. The first is a set of clear rules for what would happen if a euro-zone member were frozen out of market funding. This will be become more important as more countries join. Second is an agreement on how the ECB would be recapitalised in the unlikely event that bank failures were to leave it with big losses on its loan book, or that it were to make large outright purchases of securities that subsequently went bad. A third element of fiscal union is needed to bind not just the euro area but the EU's entire single market: a shared fund for cross-border bank bail-outs. Without an agreement on support for troubled multinational banks, an open EU market in financial services may be impossible to maintain. Ironically, such a scheme would have to include Britain and Sweden, two countries that are outside the euro zone but have lots of banking interests in other EU countries.

Warmer inside

Jun 11th 2009
From The Economist print edition

The gains outweigh the losses

THIS crisis has tested many schemes and wheezes (some to destruction), from securitised mortgages to collateralised-debt obligations, from light-touch regulation to inflation targeting. How does the euro fare in this reckoning? According to one school of thought it is a fair-weather set-up, seemingly effective when economies are expanding but poorly equipped to deal with crises and manage the pressures and conflicts of a sinking economy. Conversely, many in Brussels and Frankfurt argue that being in the euro zone helped member countries emerge relatively unscathed from the worst financial crisis since the 1930s. Which view is right?

The extreme lurches in markets during the worst of the crunch last autumn made the certainties of fixed exchange rates look enticing. One lesson from the crisis is that asset prices can be unduly volatile and often veer wildly from their true values, in ways that undermine economic stability. That goes especially for housing but is also true of other asset prices, such as exchange rates. Another message is that interest-rate policy is not as powerful a stabilising force as had been thought. Other means of shaping demand are needed to complement it. Swapping an independent monetary policy for the stability of a fixed exchange rate now seems less of a sacrifice. That also closes off the escape route of letting the currency slip if wages move out of line with productivity. Yet deflation seems such a threat precisely because prices and wages are proving less “sticky” on the way down than macroeconomic textbooks had reckoned with.

On standard gauges of competitiveness, such as real effective exchange rates, a number of euro-zone countries appear to have big problems. Yet things may look worse than they are. Measures based on relative unit wage costs across the whole economy are crude. In booming Spain and Greece, much of the heat in wages was in parts of the economy, such as construction, that serve domestic spending and are sheltered from foreign competition. Export industries may have a better chance of benefiting from a global recovery than the figures suggest at first glance.

Spain, in particular, may not be quite as uncompetitive as it seems. José Luis Escrivá, an economist at BBVA, a Madrid-based bank, reckons that Spanish exporters have performed fairly well in retaining export market share against other countries, bar super-competitive Germany. “What Spain had mostly was an import boom,” he says. Now imports are declining at a much faster rate than GDP, which will trim Spain’s current-account deficit to a more manageable size.

A recent study by the European Commission lends some support to that view. The export-market shares of Spain and Greece fell only slightly between 1999 and 2008 (see chart 7). Export growth was stronger than in Belgium, France and Portugal, if not as vibrant as in Austria, Finland, Germany and the Netherlands. Ireland’s export-market share increased over the period, even if the greatest strides were made in the euro’s early years. Perhaps its exporters, many of them big American-owned firms, were wise enough to hold back on big wage and price increases in a country that could not devalue.



Italian exports, however, were dismal. Firms in Italy lost market share faster than in any other big euro-zone country. Italy’s undoing is to specialise in industries such as textiles and furniture where competition from China and other emerging markets is particularly keen.

A devaluation might offer temporary respite for Italian exporters, but it would not be a lasting solution to being in the wrong businesses. Neither could it disguise the economy’s real problems: legal protection for jobs that stops workers moving from dying industries to growing ones; a wage-bargaining system that has made for poor matches between pay and productivity; and an unimpressive record on innovation that has inhibited the emergence of new firms in high-value-

added industries. This familiar Italian litany is the "never-ending story of things that need reform", sighs one economist.

However, there are signs of progress. Confindustria, Italy's biggest employers' body, recently signed an accord with two of the three largest trade-union confederations to overhaul the national wage system. CGIL, the largest union group, did not sign up to the deal, but the Italian government said it would go ahead anyway.

Deconstructed

Spain and Ireland have more to worry about than wage costs in export industries. Big construction busts are, as a rule, hard to recover from. At the peak of their housing booms, up to a fifth of their workers had jobs related to construction or property sales. Many of those jobs will not come back, and finding other things to do for such an army of redundant workers will take time. Ireland has a more flexible jobs market, so its recovery is likely to be swifter, if still far from painless. Its GDP is set to shrink by as much as 9% this year. Spain's economy is more hidebound, so it will take longer to revive.

It is hard to see how a devaluation would help much even if that option were available. "If Spain's main problem were competitiveness, I wouldn't worry," says Mr Gros of the CEPS: "The Phillips curve [which suggests an inverse relationship between wage inflation and unemployment] would take care of it."

Illustration by M. Morgenstern



The lack of a "fiscal euro zone", a central spending body financed by a shared pool of tax revenues, has hampered an effective response to the economic downturn. Yet without the euro things might have been a lot worse. Co-ordinating a European response amid a series of currency crises or exchange-rate rows would have been far trickier. Bond investors have become choosier about sovereign credit risk, so some euro-area borrowers have had to stump up higher coupons for their recent bond issues. But no one was frozen out of markets. Even when spreads were at their widest, Greece and Ireland, the euro-zone's high-yielders, were able to finance their borrowing needs at a reasonable cost. The security of access to financing has made the euro area even more attractive to the EU's eastern states, some of which have had to fall back on rescue loans or precautionary credit lines from the IMF.

The prospect that a euro-zone country might default on its loans, never mind leave the euro, is fairly remote. But the taboo around the subject leaves bond investors uncertain about how such a problem might be resolved if it did occur. That uncertainty should be dealt with. Policymakers have dropped hints that should one country's financing troubles spread to another, a bail-out plan is in place. Yet the risk of contagion is overblown. An orderly debt restructuring for a country within the euro zone would not be the end of the world, or indeed of the single currency. A bail-out by fellow members might do greater harm by damaging popular support for the single currency.

There is a central irony about the euro. Many of its architects saw it as a means of advancing political union in Europe and were barely interested in a monetary union as an economic venture. Their hopes have been dashed, but as a technical exercise the euro has been a huge success. The currency is accepted in vast swathes of the rich world and quite a bit of the poor world too. The value of euro banknotes in circulation and the market for euro-denominated securities already rival the dollar, a long-established currency backed by a single nation-state.

For economists such as Robert Mundell and others, who saw huge benefits in shared currencies but had despaired of politicians giving up monetary control, the euro is an exciting experiment. By contrast, the politicians that made the leap have been disappointed by the euro's failure, so far, to spur deeper political integration.

For all its shortcomings, the euro zone is far more likely to expand than shrink over the next decade. Most EU countries that remain outside, bar Britain and Sweden, are eager to join. The harm done by housing and construction booms in Ireland and Spain should be a caution to would-be members who, once inside, may get carried away by low borrowing costs. Against that, a big lesson from the crisis is not to rely too much

on short-term interest rates to rein in credit and home-loan booms. The rush to join the euro zone is surely a vote of confidence. It must be doing something right.

Sources and acknowledgments

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Netbooks

Small but disruptive

Jun 11th 2009 | SAN FRANCISCO AND TAIPEI
From The Economist print edition

Laptops are evolving—and forcing the rest of the computer industry to change

Imaginechina



IT WAS like waiting for Godot: in the end, the great man did not come. The crowd at Apple's jamboree in San Francisco this week was visibly disappointed when Steve Jobs, the computer-maker's legendary chief executive, did not even put in a brief appearance after a six-month medical leave. But another no-show was perhaps more important. Proving many techno-pundits wrong, Apple did not present a "tablet"—a pared-down computer in both size and abilities, with a touch screen. Had it done so, it might have helped settle a question that has preoccupied the personal computer (PC) industry for some time: are netbooks—cheap and basic laptops that are flying off the shelves—just a fad, or the future?

The answer is probably both, as an "iPad", or whatever Apple's device may be called, would have demonstrated. Netbooks are already being supplanted by a plethora of new gadgets, including tablets and increasingly computer-like mobile phones (see article). But the idea they embody, that a near-permanent connection to the internet permits simpler technology, is already changing the economics of the PC business.

Simple, low-cost laptops are not a new idea. There were several abortive attempts to make them in the 1990s, but big computer-makers soon dropped them for fear that they might undermine sales of traditional laptops. In 2005 a charity called One Laptop Per Child designed an ultra-cheap laptop for the developing world. That inspired Asus, a Taiwanese PC-maker, to develop one of its own, called the Eee PC, which it started selling in late 2007 for $250.

The timing was perfect. A few months later, the credit crunch hit. At the same time, Intel started selling its cheap and power-saving new processor chip, called Atom. By the end of 2008, Asus had sold nearly 5m Eees and all its rivals had jumped on the bandwagon. In total, 21m netbooks will ship this year, almost twice the number in 2008 and more than 15% of the entire market for laptops, according to Gartner, a market-research firm.

Yet as netbooks have become more popular, many of them have also become more sophisticated. Asus's first Eee PC was a puny device with a screen measuring only seven inches (18 centimetres) diagonally, a midget keyboard and flash memory instead of a hard disk. It also ran Linux, a free operating system. But consumers in the rich world wanted more. As a result, most of the new devices on display in early June at Computex, a trade show in Taipei, boasted at least ten-inch screens, full-size keyboards and sizeable hard

disks, and they ran Windows XP, an old version of Microsoft's flagship operating system. Many models now go for $600 a pop.

Other gadgets on display at Computex included prototypes of "mobile internet devices", which sit somewhere between smart-phones and netbooks, "net-tops" (tiny desktops) and "all-in-ones" with touch-screens instead of keyboards, to hang on the fridge, for instance. "The PC industry will ultimately mirror the car industry," says Ranjit Atwal, an analyst at Gartner. "There will be something for every need and every taste."

Yet although netbooks have acquired many frills and mutated into new forms, the theory behind them endures: computers do not need to be stuffed with the latest whizz-bang technology if they have a high-speed connection to the "cloud" of services available online. At Computex firms showed devices equipped with WiMAX, a new wireless technology that allows for fast, ubiquitous wireless connections.

It is this combination of connectivity and cloud computing that makes netbooks and their successors so disruptive. Some mobile-network operators now throw in free netbooks if subscribers sign up for a mobile-broadband contract. This will put further pressure on prices, since mobile operators have more bargaining power than individual consumers, although it also opens a huge new distribution channel for computer-makers.

More important, netbooks and similar devices could weaken Microsoft and Intel, which have so far dominated the PC industry and extracted most of the profits. To keep Linux off most netbooks, Microsoft has had to discount Windows XP from $40-45 per copy to $10-15. This, along with the general weakness of the PC market, explains why its earnings dropped almost a third in the first quarter of this year. To make more money from netbooks, it will offer a minimalist "starter" edition of Windows 7, the new version of its operating system due out in October.

Intel, by contrast, has so far mainly benefited from the netbook craze, which has created a huge market for its Atom chip. The firm insists this has neither cannibalised sales of its other chips as much as feared nor put pressure on its lofty margins, since Atom costs less to make. Still, just as with Linux, there is a credible alternative to Atom: processors based on designs by ARM, a British firm, which already power most of the world's mobile phones. Several Taiwanese PC-makers are working on a netbook-like gadget that would be powered by an ARM chip and run Android, a variety of Linux developed by Google for use on smart-phones.

At Computex, Acer announced that it would use Android together with an Intel chip. Other firms are expected to follow suit. Intel is also pushing another version of Linux, called Moblin. Its long partnership with Microsoft notwithstanding, Intel does not seem to care what operating system netbooks use, provided they contain the firm's chips.

Linux may also prove popular for tablets, a market that Apple is likely to energise when it finally launches its much-awaited new device (though any Apple tablet will run its own operating system). The reason it did not happen this week, some say, was that either the tablet or Mr Jobs, who would like to present it personally, is not yet ready for action. Unlike Godot, Mr Jobs and the new gadget are likely to appear eventually—probably in time for the holiday season.

Smart-phone wars

Pre conceived

Jun 11th 2009 | SAN FRANCISCO
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Stiffer competition for the smart-phone throne

THIS will hardly be a vintage year for the mobile-phone industry. Gartner, a market-research firm, reckons global handset sales will shrink by around 4% to 1.2 billion units. Yet despite the gloom the industry is still pumping out new products. On June 6th Palm, a firm that pioneered hand-held digital devices, started selling a phone called the Pre. Two days later Apple unveiled souped-up versions of its popular iPhone.

Both firms are hoping to carve out bigger slices of the market for smart-phones. In addition to allowing people to make calls and check e-mail, these can run programs, or "apps", designed by third-party developers. This helps explain why demand for them has been growing like mad, even though the rest of the market is in the doldrums. Gartner estimates that sales of smart-phones will soar by 27% this year, to 177m units.

BLOOMBERG NEWS



Post-Pre-purchase euphoria

Palm hopes the Pre will revive its flagging fortunes. Two years ago the company took the bold step of rebuilding its software-engineering team almost from scratch, importing fresh talent from rivals including Apple. (An ex-Apple manager was appointed chief executive on June 10th.) It then scrapped its antediluvian operating system and developed an entirely new one that has won plaudits from reviewers. The Pre, which uses the new software, is intended to be as user-friendly as the iPhone.

But the company still faces an uphill struggle. For one thing, there is a plethora of smart-phone operating systems already available, including Nokia's market-leading Symbian and Google's Android. For another, the shelves at Palm's online app store are virtually empty, whilst Apple's are groaning with nearly 50,000 apps, with more than a billion downloads since it launched last July.

Apple is determined to extend its lead. As it launched its new iPhone this week, it cut the price of its existing model from $199 to $99 to attract more customers. The company hopes that broadening the iPhone's appeal will encourage developers to devote even more energy to creating apps for it. Apple is also making it easier for programmers to collect money from follow-on purchases after a customer has paid to download an app, providing a further incentive to innovate.

Such savvy moves will reinforce a virtuous circle: the more apps that are available for the iPhone, the more attractive it will become to prospective purchasers. This will also make it tougher than ever for the Pre and other smart-phones to take a bite out of Apple's rapidly growing market share.

Arcandor's bankruptcy

The till is bare

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A retail firm's collapse marks the limit of government bail-outs in Germany

ARCANDOR, which owns Germany's biggest chain of department stores, Karstadt, certainly did not fail because it gave its customers too little choice. Its stores offer the usual mix of perfumes, clothes and kitchen appliances. Its website allows customers to buy everything from package holidays to small motorcycles. Being all things to all people proved, however, to be a loser's game. On June 9th the firm filed for insolvency after Germany's coalition government turned down its second request for a bail-out.

In applying for €437m ($611m) in aid, the company had tried to present itself as a hapless casualty of the credit crunch and ensuing recession. Yet the firm's problems predate the global economic crisis and are, in many respects, the creation of its former boss, Thomas Middelhoff, a celebrated executive who once headed Bertelsmann, a media group, and who left in February, breezily insisting the firm was in good health. Mr Middelhoff spun off Arcandor's property portfolio in 2007, raising as much as €4.5 billion, but saddling its department stores with high rents. In Germany's difficult retail market, where parsimonious consumers and fierce competition have kept margins paper-thin for years, this was risky financial engineering.

The strategy also clashed with a move by shoppers away from department stores that has left the world's high streets divided between specialist stores selling expensive goods and discounters selling cheap ones. "There is a long-term trend towards reduced market share for this sector," says Ira Kalish, a retailing expert at Deloitte, a consulting firm. Last year Karstadt's 91 stores, icons of almost every German city, posted an operating loss of €272m on sales of more than €4 billion.

Karstadt's claim to be a victim of circumstance is further undermined by the relative success of its main competitor, the Kaufhof chain of department stores, which belongs to a firm called Metro. Its efforts to weather the downturn by cutting costs, even as it cast itself as a more upmarket brand, produced operating profits of €113m last year on sales of €3.5 billion.

The pain of insolvency for Arcandor's 43,000 employees (and for Angela Merkel's Christian Democratic Union, which faces elections in September) will probably be salved by the likely takeover of most of Arcandor's department stores by Metro. It wants to combine them with Kaufhof in preparation for a possible listing.

The bigger winners, however, are Ms Merkel and her hard-nosed economy minister Karl-Theodor zu Guttenberg, who has been leaning against the wind of state intervention that has buffeted Germany and the rest of Europe. A few weeks ago, as Germany offered generous loan guarantees to Opel, General Motors's European unit, Arcandor's chances of securing a handout of its own seemed good. Franz Müntefering, the leader of the left-leaning Social Democratic Party, which is both the main rival and coalition partner of the Christian Democrats, offered Arcandor fervent promises of support.

Yet Ms Merkel's resolve appears to have been strengthened by her party's strong showing in European elections last week. In turning down Arcandor she is drawing a firm line on bail-outs. Big industrial firms facing a collapse of export markets such as Heidelberger Druck, the world's biggest maker of printing presses, are likely recipients. Companies that are authors of their own misfortune, such as Porsche, a carmaker which overstretched itself in an attempted takeover of rival Volkswagen, will get a less receptive hearing.

By protecting its taxpayers, however, the German government may harm Britain's. Even optimistic valuations suggest that Arcandor's debts exceed its assets by €500m or more. One of its biggest creditors is Royal Bank of Scotland, which recently became a ward of the British state after a bail-out of its own.

India's cheap housing boom

The nano home

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Indian property developers cater to the masses with low-cost housing

LAST month ten-year-old Azharuddin Ismail was woken in the middle of the night by the sound of bulldozers. As policemen beat him with a bamboo stick to shoo him and his family away, his home in Mumbai's slums was swiftly demolished. Azhar, a celebrity since appearing in the film "Slumdog Millionaire", has since been given a new home by the filmmakers. But other residents were not so fortunate.

India's cities need at least 25m more homes, according to report from McKinsey, a consultancy, and the Federation of Indian Chambers of Commerce. In Mumbai, the commercial capital, more than 8m people now live in shantytowns, often paying substantial rent for the privilege. But buying a home of their own is way out of reach for most of them: a 70-square-metre flat in the centre of the city costs $500,000 or so.

Tata Housing



Small flats, big profits

Matheran Realty is one of several firms that think they have a solution: ultra-low-cost housing. In Karjat, 90km east of Mumbai, Matheran Realty is in the process of building 15,000 flats with prices starting at just 210,000 rupees ($4,500) for 19-square-metre units. Tata, the firm that makes the $2,500 "Nano" car, is building 1,300 basic units at Boisar, about 100km north of the city, and may add more. Priced at 390,000-670,000 rupees each, they are already oversubscribed. Other firms are planning similar developments elsewhere in India.

The cost is being kept low chiefly because the flats are being built outside big cities, where land is much cheaper. Owners are expected to commute. The units are also very small and spartan. The simplest consist of a single room with a sink in the corner and a toilet behind a partition. They are in buildings of no more than three storeys, so there is no need for expensive structural works. Instead of bricks, lightweight moulded concrete blocks are used for the walls. The concrete is often made with foam, fly-ash or other waste materials to make it lighter as well as cheaper. There are no lifts and just one staircase per block. All this means that the homes can be built very quickly and with unskilled labour.

The developers say the potential for very cheap housing in India is huge. Many of those living in slums today are employed as drivers, factory workers or tailors, with incomes of around 90,000 rupees a year—easily enough to afford a flat which costs 200,000-400,000 rupees. According to Ashish Karamchandani of Monitor Group, another consulting firm, India has 23m urban families with incomes of 60,000-130,000 rupees a year. Including rural areas, Tata Housing sees an even larger market of 180m households earning between 90,000 and 200,000 rupees.

Until very recently one of the biggest hurdles was finance. Banks were unwilling to lend money to people without credit histories or proof of permanent residence. But two government-owned banks—the National Housing Bank and the National Bank for Agriculture and Rural Development—have agreed to provide funds to finance companies so that they can offer mortgages to such buyers. To reduce risk, buyers must put down at least a quarter of the purchase price and employers must confirm their income. Borrowers are then charged little more interest than those with an established credit history.

Lenders and developers are convinced that they have struck gold. Who would have guessed that the combination of subprime loans and a building boom would have become attractive again so soon?

The plight of Ford

A stony road

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In both America and Europe, Ford faces government-backed rivals

SPARE a thought for Ford Motor Company, which lost $14.7 billion last year but is battling on, trying to fix its problems with hardly a shred of government help in either America or Europe. In America its two domestic rivals, General Motors (GM) and Chrysler, are using bankruptcy protection and $62 billion from the Treasury to shrink their debt, reduce the cost of their obligations to retired workers and prune their sprawling dealer networks. GMAC, the lender that provides loans to the customers and dealers of both firms, but not those of Ford, has received $13.5 billion of funding from the government. In the European Union, meanwhile, despite strict rules intended to stop states from giving an unfair advantage to “national champions”, France and Germany have rushed to prop up three of Ford’s main competitors.

Ford escaped the fate of the other two Detroit carmakers by tapping credit markets just before they began to freeze over. It risked everything by pledging all of its North American assets as collateral, raising $23.6 billion in 2006. But some think the gamble has backfired. The Supreme Court’s decision not to interfere in Fiat’s purchase of a stake in Chrysler, concluded on June 10th, should help Chrysler and GM emerge as more daunting competitors soon. In particular, a streamlined GM, shorn of several ailing brands and 2,600 dealers, and with its debts reduced to $17 billion, will be able to generate more cash to revamp its line-up while focusing its marketing budget on its best vehicles.

By contrast, Ford began the year with debts of $36 billion. Because of state franchise laws that bankruptcy circumvents, it has only been able to trim the ranks of its dealers by 15% since 2005 to 3,700. It is also unclear whether the United Auto Workers union is willing to offer Ford the concessions it made to GM and Chrysler under the pressure of imminent collapse.

Moreover, GMAC can borrow more cheaply than Ford’s wholly owned finance arm, Ford Credit. On June 3rd GMAC (which used to be owned by GM, but now belongs mainly to the government and Cerberus Capital Management, a private-equity firm) borrowed $3.5 billion for three and a half years at a cost of 2.2% a year, with a guarantee from the Federal Deposit Insurance Corporation (FDIC). Just a few days earlier, Ford had issued $1.1 billion-worth of five-year bonds at 8% interest.

Yet Ford is still happy with its decision to avoid the government’s embrace. Polls show that some 70% of taxpayers disapprove of the bail-outs of GM and Chrysler. Research by Edmunds.com, an automotive website, suggests that Ford is likely to win much of the custom of those who would rather not buy a car from “Government Motors”. Moreover, if a scaled-down GM no longer floods the market with discounted vehicles, Ford should be able to raise its own prices. It has capitalised on each morsel of good news to swap debt for equity, gradually reducing its burden by $10 billion so far this year. The dilution does not appear to have hurt Ford’s share price, which is up four-fold since late February.

It is the European bail-outs that really rile Ford. Wolfgang Schneider, who handles its relations with European governments, says, “In the US, it is a level playing field because we could have chosen to go the route of GM and Chrysler, but in Europe it is not.” Although it has about 10% of the European market, putting it in third place behind PSA Peugeot Citroën and Volkswagen, Ford is nobody’s “home team”. It makes cars in Germany, Spain and Belgium. Britain, by far its biggest market, only provides engines and vans.

Ford has complained to the European Commission about the €6.5 billion ($8.4 billion) that the French government lent to PSA and Renault in February on terms no commercial lender would have offered. It is even more exercised about the €4.5 billion in loan guarantees that the German government has promised the new owner of Opel on top of the €1.5 billion in bridging finance it has already provided. “What are the conditions?” asks Mr Schneider, “There is no transparency.”

Ford’s protests are likely to continue to fall on deaf ears. One answer might be to move some production

back to Britain, where, despite ending car assembly in 2002 (after 90 years), Ford is still the nation’s favourite automotive brand. Sadly, as Mr Schneider observes, “The UK is the only country that plays by the rules.”

Executive pay in America

Principles, not pitchforks

Jun 11th 2009 | SAN FRANCISCO
From The Economist print edition

Some sensible new proposals for curbing corporate greed

Illustration by David Simonds



ALTHOUGH the debate about excessive executive pay in America has been heated, cool heads prevailed when the time came to tackle the problem. On June 10th Tim Geithner, America's treasury secretary, said the government would not impose fierce restrictions such as caps on pay. Nor would it meddle in the detail of compensation packages. Instead, it wants companies to adopt a series of broad principles on pay and it intends to make it easier for shareholders to ensure that they do so.

This approach will infuriate pitchfork populists, who were hoping the Obama administration would impose a regulatory straitjacket on corporate pay after an outcry earlier this year over hefty bonuses dished out at firms rescued with taxpayers' cash. But Mr Geithner warned that such an approach would ultimately be "counterproductive". In practice only firms that have been bailed out will face stiff restrictions on bonuses and other forms of pay. Some will have to submit senior managers' compensation for review by a new, government-appointed "special master".

The rest of corporate America will escape such constraints, but the government still wants firms to take a fresh look at the way they reward staff. Among other things, Mr Geithner urged companies to avoid plans that offer big rewards for short-term risk-taking and called for a reconsideration of "golden parachutes", which can produce payouts that would make Croesus blush for bosses ousted for poor performance. He also exhorted firms to be more open with investors about the logic behind their decisions on pay.

Contrary to received wisdom, the process of linking pay to performance works reasonably well in America—witness the large number of bosses whose remuneration has plummeted during the recession. Nevertheless, several executives have made a mint even though their firms' track records have been lousy. Some experts say this is because they have packed their firms' remuneration committees with pals who are friendly to their cause. To address this issue, the government will push for legislation to give the Securities and Exchange Commission (SEC) powers to ensure that compensation committees are truly independent of management.

It also wants the SEC to ensure that consultants who advise such committees on pay are independent as well. Some of these work for bigger firms that sell a variety of services, which may make them reluctant to attack a boss's proposed pay package for fear of jeopardising other business. Consultancies say such concerns are groundless, but critics note that auditors said the same thing when they were pitching consulting services to audit clients. Yet the Sarbanes-Oxley act significantly restricted auditors' ability to cross-sell other services in order to bolster their independence. Some experts think similar restrictions should now be imposed on compensation consultants, too.

Fixing executive pay will require more than just a few regulatory tweaks. Shareholders also need a chance to review and influence pay deals before they are inked. This week Mr Geithner said the government intends to give them one, by backing efforts in Congress that would require companies to submit their pay policies to an annual vote. Experience in Europe, where such ballots are common, has shown they encourage boards to consult more actively with shareholders on pay issues ahead of formal polls. That the current administration is so keen on "say on pay" is hardly surprising: the last time a measure proposing the process made it to the Senate, back in 2007, it was sponsored by a senator called Barack Obama.

Face value

Steel and brass

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From The Economist print edition

Marius Kloppers, the boss of the world's biggest mining firm, gets his way in the end

AP



BHP BILLITON and Rio Tinto, two of the world's biggest mining firms, run some of the longest trains on earth. Six locomotives are hitched to 300 freight cars in a chain that stretches for three kilometres. Each train hauls as much as 26,000 tonnes of iron ore 400km across the Pilbara region of north-western Australia, from the mineral ridges of the interior to the scrubby coastal plain. They run around the clock, day in, day out, down dedicated railway lines from mines such as Mount Tom Price and Mount Newman to the ports of Cape Lambert, Dampier and Port Hedland. There, a bewildering network of cranes and conveyors tips the ore out of the railroad cars, mixes it into blends of varying purity and loads it into ships bound for China, Japan and Korea. More vessels queue up outside the harbours waiting for a free berth. Mining on this scale is nothing to do with shafts, lifts and tunnels; it is about moving mountains, endlessly, to the sea. It calls for detailed planning and precise timing to keep the ore flowing steadily and smoothly.

Being boss of a mining company, by comparison, has been an unpredictable, lurching rollercoaster ride of late. No one knows this better than Marius Kloppers, the South African who became chief executive of BHP Billiton in October 2007 and almost immediately plunged the global mining business into turmoil by launching a $190 billion bid for Rio Tinto. Months of uncertainty about Rio's fate ensued—only to be resolved, much as Mr Kloppers had originally planned, this month.

Mining bosses used to be geologists who had worked their way up from the rock face to the boardroom. No longer: Mr Kloppers is typical of the new breed, as happy hunting for riches in the canyons of Wall Street as along the escarpments of the Pilbara. He rounded off degrees in chemical engineering (from the University of Pretoria) and materials science (from the Massachusetts Institute of Technology) with an MBA from INSEAD, arguably Europe's best business school, and several years as a management consultant at McKinsey. His clipped South African accent, intense gaze and meticulous vegetarian diet all suggest focus and determination. He is sharp-witted, but with more than a hint of brawn: a South African contemporary recalls him flattening several opponents in the opening minutes of a 1980s school rugby championship in Johannesburg.

A generation later he was equally quick off the mark. He made his audacious bid for Rio Tinto barely six weeks after becoming BHP's boss. It would have been one of the biggest mergers ever. At the time iron ore prices were defying gravity thanks to the rapid growth of the Chinese and Indian economies. But the price of mining was rising too, thanks to a shortage of workers and equipment, which was causing acute problems for both BHP and Rio at their remote mines in the Pilbara. The logical response was to merge

their operations there, to save on procurement and rationalise their overlapping infrastructure.

When in a hole

But Rio argued that Mr Kloppers's offer undervalued its assets in the Pilbara in particular. And Rio's boss, Tom Albanese, had saddled Rio with $40 billion in debt from the purchase of Alcan, a Canadian aluminium firm it secured after a bidding war with America's Alcoa. As the credit crunch set in, that burden began to look unbearable both to Rio and to Mr Kloppers. Worse, the commodities bubble burst: metals prices fell by over half between March and November 2008. Mining groups' share prices tumbled too. The offer of three BHP shares for one Rio share was worth only $66 billion by November. There was also concern that Europe's competition authorities might balk at a deal which would put the combined entity in control of roughly 40% of the world's international trade in iron ore, and force it to sell some assets at a time when it would be difficult to get a good price. So Mr Kloppers eventually stopped digging and dropped the bid, at considerable cost to BHP and to his own reputation.

The industry's attention soon turned to another transaction. Rio was seeking to shore up its finances (and fend off any future bids) by bringing in Chinalco, a state-owned Chinese firm, as a big shareholder. Mr Albanese championed a deal in which Chinalco would double its stake in Rio to 18% and buy shares in some prize assets (including iron-ore mines in the Pilbara). Mr Kloppers was worried about the Chinese government muscling in on the iron-ore business, since China's state-owned steelmakers are among his biggest customers. He lobbied the Australian government to block the deal. But it was objections from Rio's shareholders, and a recovery in commodities prices which lifted mining firms' share prices and made the proposed deal with Chinalco look too generous, that ultimately scuppered the plan.

Mr Kloppers was waiting in the wings. BHP and Rio immediately announced the outlines of an agreement to pool their iron-ore business in the Pilbara. BHP will pay Rio $5.8 billion to bring its interest in the venture up to 50%. The two firms' mines will supply iron ore in equal volumes to the ships of both companies, to be delivered to their respective customers. The pair say the tie-up will yield cumulative savings of $10 billion. The biggest gain will come from melding their rail operations, providing shorter routes to the sea from some mines and thus cheaper ways to achieve the blend of ores required by certain customers.

Crucially, Mr Kloppers gets to extract much of the value he saw in his planned merger, but without the risk of increased debt. There will be many more bumps ahead: European, Chinese and Korean steelmakers are objecting to the joint venture, which they say will concentrate too much power in the hands of a single firm. The premier of Western Australia, the state where the Pilbara is located, is muttering about increasing royalties. But the steely Mr Kloppers, his reputation restored, looks likely to press on as persistently as the trains rumbling across the Pilbara.

Government debt

The big sweat

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From The Economist print edition

Banking catastrophes and recession have led to vast increases in rich countries' public debts. Getting their finances back into shape will be painful

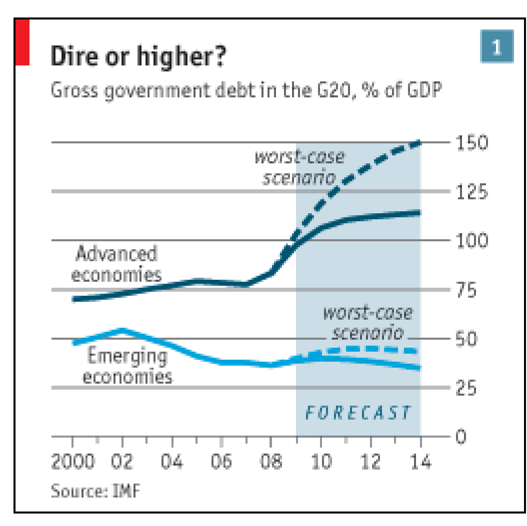
Illustration by Daniel Mackie



OVERINDULGENCE has a price. After years of scoffing food and swilling booze, the cost is physical. After a debt-fuelled financial bender, it is fiscal. Governments have been propping up the world economy with a borrowing spree of their own. The recession has drained tax revenues and policymakers have been spending unprecedented sums to get their economies going and support their banks. Sovereign debt is piling up.

According to a study by economists at the IMF, published on June 9th, by next year the gross public debt of the ten richest countries attending the summits of the G20 club of big economies will reach 106% of GDP, up from 78% in 2007. That translates into more than $9 trillion of extra debt in three years.

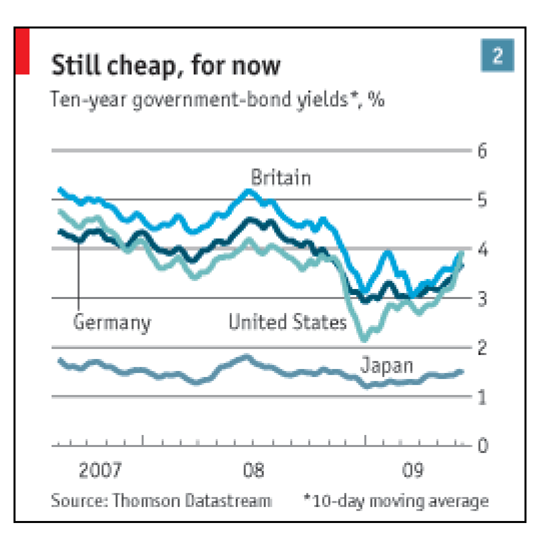
There is more to come. Because economic growth is likely to be weak for several years after the recession ends, especially in countries such as America and Britain where over-indebted consumers must rebuild their savings, budget deficits will remain big. The IMF economists' baseline is that the government debt of the rich ten will hit 114% of GDP by 2014. Under a darker scenario in which economies languish for longer while fears about governments' solvency push interest rates up, the debt ratio could be 150% (see chart 1).



Governments have never borrowed so much in peacetime. Their huge debts will shape the world economy for a decade. In the short term the extra borrowing is prudent: governments must expand their balance-sheets to counter the savage pace at which firms and households are cutting back. Were governments not stepping in, the private shift to thrift would be causing an even deeper recession. Tax revenues would fall by more, banks would be even wobblier and public borrowing might end up even higher.

So far, the flight from risk that has made government intervention necessary has also minimised its cost. Investors have flocked to the safety of government bonds, allowing sovereign borrowers to raise

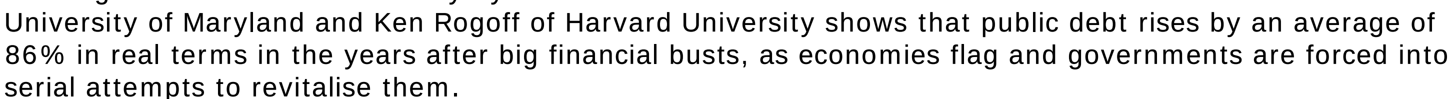
money cheaply. Although yields have risen this year, governments in most big economies are still paying less than they were when the crisis began in 2007 (see chart 2).



The real questions concern the medium term. How much damage will greater indebtedness do to economic growth and governments' creditworthiness? Borrowing on today's scale is plainly unsustainable, but will the rich world's governments be able to contain their debt burdens through budgetary discipline alone, or will they be tempted to turn to inflation or even forced to default? An assessment of these risks requires a look at the crises of the past, the financial markets of the present and the timeless arithmetic of debt.



History suggests that a big build-up of public debt is all but inevitable given the magnitude of the recent crash. A study of 14 severe banking crises in the 20th century by Carmen Reinhart of the University of Maryland and Ken Rogoff of Harvard University shows that public debt rises by an average of 86% in real terms in the years after big financial busts, as economies flag and governments are forced into serial attempts to revitalise them.



Default or high inflation are common. In the 1930s even America and Britain changed the terms of their government debt. America abrogated the "gold clause" (which fixed the payment of interest and principal in terms of the metal) after leaving the gold standard. Britain restructured the terms of some war bonds. The debt burdens of Germany after the first world war and Japan after the second were slashed by hyperinflation.

Since the 1940s no advanced economy has defaulted on its bonds (though numerous emerging ones have). And many rich-world governments have been able to lighten their debt burdens without resorting to high inflation. Britain's public-debt ratio soared to 250% of GDP as a result of the second world war and America's exceeded 100%. Both fell sharply in later decades, thanks largely to fast growth.

In the past 20 years several smaller rich economies, including Canada, Denmark and Ireland, slimmed their public debt by 40% of GDP or more as economic growth accelerated and budgets were kept tight. Ireland was conspicuously successful: in 1987 its gross debt was 109% of GDP; by 2007 it was down to 25%. Another smallish country, Sweden, proved that public finances can bounce back quickly from a banking bust. In the early 1990s its government-debt burden went up from 40% of GDP to more than 70%, but fell to below 50% by 2000.

Alas, there are plenty of reasons why a quick rebound will be harder today. The number of countries involved makes it less likely that any of them can count on exports to boost their economic recovery, as Sweden did. Because households will need to save much more and growth may be sluggish for several years, Japan may be a more relevant precedent. Years of stagnation after its property bubble burst have almost tripled Japan's public-debt ratio, from 65% of GDP in 1990 to more than 170% now.

Governments can no longer rely on some forces that aided a return to fiscal fitness in the past. During the second world war capital could not flee, and governments controlled prices and could appeal to patriotism. Now they must make their case in global capital markets. More recently Ireland and others were helped by steep falls in interest rates. With rates already low, that bonus will not recur.

Nor is the financial crisis the only cause of budgetary strain. In America, for instance, Barack Obama's administration has ambitious plans for broader health-care coverage, though it promises to pay for it. Worse, the biggest peacetime jump in the rich world's public debt is taking place just before a slow, secular collapse in most countries' public finances as workers age and the costs of health care rise. According to the IMF's calculations, the present value of the fiscal cost of an ageing population is, on average, ten times that of the financial crisis. Left unchecked, demographic pressures will send the combined public debt of the big rich economies towards 200% of GDP by 2030.

The sheer scale of their fiscal burdens may tempt governments to lighten their loads by inflation or even outright default. Inflation seems increasingly plausible because many central banks are already printing money to buy government bonds. To fiscal pessimists this is but a small step from printing money simply to pay the government's bills. Adding to their worries, many economists argue that a bout of modest inflation would be the least painful way to ease the financial hangover.

The rich world's build-up of debt may also cause changes in countries' relative creditworthiness. Investors have long viewed emerging economies as riskier sovereign borrowers than rich ones, because of their history of macroeconomic instability and more frequent defaults. But the biggest emerging economies are now by and large in better fiscal shape than their richer fellows, and that discrepancy is set to widen. The emerging members of the G20 had a ratio of public debt to GDP of 38% in 2007. By 2014, says the IMF study, this is likely to fall to 35%, less than a third of the rich world's average. As a result the gap between the yields investors demand from rich and emerging economies' bonds is likely to narrow.

Measuring market pressure

Uncertainty about all this has been evident in bond markets (and, somewhat erratically, in the prices of sovereign credit-default swaps: see article). Although yields are broadly low, prices have been volatile. Earlier this year the markets' fears were focused on weaker members of the euro area, notably Greece, Ireland, Portugal and Spain. In mid-March yields on long-term Greek and Irish government bonds hit 6%, almost twice that on German bonds. Without their own currencies these countries cannot unilaterally inflate away their debt, so the worry lies in the increased risk of default. All four have had their debt downgraded by the big credit-rating agencies. Ireland was marked down again by Standard & Poor's on June 8th.

Lately markets have also been paying attention to America and Britain. Standard & Poor's put a negative outlook on Britain's AAA rating last month. Yields on American Treasury bonds have risen sharply. On June 10th the yield on ten-year bonds came within a whisker of 4%; late last year it was not far above 2%. Ben Bernanke, head of the Federal Reserve, has attributed some of this increase to concerns about America's fiscal future. But much of it, he believes, is due to an ebbing of the panic that sent investors rushing to buy government debt last year. Because rising sovereign yields have been accompanied by narrower spreads on riskier debt, such as lower-grade corporate bonds, this is plausible.

Investors' uncertainty is not surprising. To gauge governments' ability and willingness to carry debt burdens, they must apply both the laws of arithmetic and less precise political and economic calculations. Arithmetically, a government's debt burden is sustainable if it can pay the interest without borrowing more. Otherwise the government will eventually fall into a debt trap, borrowing ever more just to service earlier debt. In practice merely stabilising debt ratios at a higher level may not be enough, because extra public debt crowds out private investment and drags down long-term growth. A better goal is to work off big increases in debt. How difficult that is depends on the size of the debt, the pace at which the economy grows and the interest rate the government must pay.

Suppose a country's gross public debt is 100% of its GDP. If the economy grows by 4% in nominal terms and long-term interest rates are 5%, the government will need a primary budget surplus—ie, before interest payments—of 1% of GDP to keep its debt ratio unchanged. To work off a rise of ten percentage points in the debt ratio over ten years requires an additional percentage point on the primary surplus.

This arithmetic suggests that the projected 36-point rise in indebtedness between 2007 and 2014 should not in itself be a calamity. It also implies that countries which entered the financial crisis with modest burdens have more room for manoeuvre than those already deeply in debt. Some of the hardest-hit countries, such as Ireland and Spain, began with low debt ratios, making default extremely unlikely, at least in the short term. Italy and Japan were hemmed in from the start. America met the crash with a gross debt ratio of just above 60% of GDP. Germany's ratio was similar and Britain's a bit lower (see table 3).

The good, the bad and the ugly 3

Government debt, % of GDP

	Gross debt 2007	Net debt 2007	Gross debt 2014*	Fiscal adjustment required†
Australia	15.4	-6.0	16.6	1.2
Britain	46.9	30.2	87.8	5.7
Canada	64.1	23.4	66.2	1.0
France	70.1	34.4	89.7	4.5
Germany	65.5	44.5	91.0	1.8
Italy	113.2	87.6	129.4	4.8
Japan	170.6	85.9	234.2	14.3
South Korea	28.9	-37.7	51.8	-0.7
Spain	42.7	19.1	69.2	3.1
United States	62.9	43.0	106.7	3.5

*Forecast †Difference between forecast primary budget balance in 2014 and primary balance needed for debt sustainability as calculated by the IMF

Sources: IMF; OECD; *The Economist*

Gross debt is a good measure of the public sector's demands from financial markets, since it includes all outstanding government paper. It is the measure used in the IMF study. But it does not give a full picture. Some countries include internal government IOUs in their figures: America, for instance, counts the bonds held in its government pension plan. Because other countries do not, that overstates America's relative gross debt burden. Washington policymakers prefer to look at "debt held by the public", which excludes those internal IOUs. At 37% of GDP in 2007, it puts America in a better light.

Although gross debt is the best guide to governments' financial obligations, net debt, which subtracts the value of their assets, is a better indicator of their creditworthiness. The difference can be huge. Norway's gross debt was close to 60% of GDP in 2007, but thanks to its oil-based sovereign-wealth fund it had a net surplus of almost 150% of GDP. Since Japan's government controls vast assets, notably the Japan Post bank, its net debt, at 86% of GDP, is far lower than its gross debt. After financial crises, the gap can widen a lot. When governments take over failed banks their gross debt soars, but because the accompanying assets have value net debt goes up by much less. Comparing net debt across countries is harder than comparing gross debt, because estimating the value of government assets is hard. Even so, the ranking of big rich economies' burdens, and of the likely increases in them, is much the same on both measures.

Furthermore, calculations about the sustainability of debt must take into account more than just its size relative to GDP. As a rule, countries that issue debt in their own currency to their own citizens are less vulnerable than those that must sell bonds in foreign currencies or that depend heavily on foreign lenders. Emerging economies, which have usually borrowed from abroad, have often faced crises with debt burdens of less than 60% of GDP. Japan, with a large pool of private domestic savings, funds a debt burden almost three times as big as that easily—and cheaply. Persistent economic weakness has pressed yields on Japanese government bonds down from 7% in 1990 to below 2%.

This gives some comfort to rich countries with rising debt burdens—especially America, because the dollar is the world's reserve currency. The rise in private saving after the financial crisis should also hold down the cost of borrowing. That said, America, like Britain and many other countries but unlike Japan, relies on foreign investors, who may prove less willing to fund a much larger debt burden. In the past a bigger burden in America has led to slightly higher long-term interest rates. One often-cited study suggests that a rise of ten percentage points in the ratio of debt to GDP increases long-term bond yields by a third of a percentage point. If America's debt burden gets a lot bigger, however, this could change. Studies from continental Europe suggest that the extra interest-rate cost rises with indebtedness.

The budget balance, which indicates the prudence of fiscal policy from year to year, also helps in determining a government's vulnerability. On that measure the economies of the euro zone fare relatively well. Germany, for instance, entered the crisis with a primary surplus. Both Britain and America had deficits.

From prudence to profligacy

Unfortunately, some countries that seemed to be in decent shape, such as Ireland and Spain, turn out to have relied too much on revenues from soaring property prices and have seen their tax bases collapse. The IMF's economists reckon that by 2014 Ireland's gross public debt is likely to exceed 120% of GDP, undoing all the gains from the past two decades, while its primary deficit will still be 6.7% of GDP. In Britain, which counted on taxes from financial assets and property, the primary deficit is still likely to be above 3% of GDP in 2014, one of the highest among the world's big rich economies.

Illustration by Daniel Mackie

All this is daunting enough. But for a full sense of the task facing governments, demographic pressures have to be added to the crisis-related damage. On this score all the world's big rich economies are in trouble, but some are worse placed than others—which implies that they will have to run bigger primary budget surpluses. The present value of the increase in America's future age-related budget obligations is about five times its GDP. For Britain, the figure is about three times.

To estimate just how much pain lies ahead, the IMF's economists put all these elements together, assume that long-term interest rates exceed economic growth rates by a percentage point (the long-term pre-crisis average) and then calculate by how much primary budget balances would have to improve in order to bring gross debt ratios to a sustainable level. The economists define this level as 60% or, for Japan, half of today's figure (ie, 85%). Their results suggest that Ireland and Japan have most to do. Both would need to boost their primary balances by more than 12% of GDP, compared with what is forecast for 2014. Britain would need an improvement of close to 6%. The gap in America is 3.5% and in Germany just under 2%.

All told the outlook is bleak. In a few countries, the financial crisis has badly damaged the public finances. Elsewhere it has accelerated a chronic age-related deterioration. Everywhere the short-term fiscal pain is much smaller than the long-term mess that lies ahead. Unless belts are

tightened by several notches, real interest rates are sure to rise, as will the risk premiums on many governments' debt. Economic growth will suffer and sovereign-debt crises will become more likely.

Somehow, governments have to avoid such a catastrophe without killing the recovery by tightening policy too soon. Japan made that mistake when concerns about its growing public debt led its government to increase the consumption tax in 1997, which helped to send the economy back into recession. Yet doing nothing could have much the same effect, because investors' fears about fiscal sustainability will push up bond yields, which also could stifle the recovery.

The best way out is to tackle the costs of ageing head-on by, for instance, raising retirement ages further. That would brighten the medium-term fiscal outlook without damaging demand now. Broadly, spending cuts should be preferred to tax increases. And rather than raise tax rates, governments would do better to improve their tax codes, broadening the base and eliminating distortive loopholes (such as preferential treatment of housing). Other priorities will vary from one country to the next. But after today's borrowing binge, doing nothing is no longer an option.

Economist.com FINANCE & ECONOMICS

Repaying TARP money

Hauled to safety

Jun 11th 2009 | NEW YORK
From The Economist print edition

Funds returned by healthy big banks will be redeployed among smaller ones

Illustration by S. Kambayashi



SINCE the economy hit an iceberg in October, America's biggest banks have felt a bit like shipwreck survivors: required to wear lifebelts provided by the government, despite complaints from some that they could have kept afloat on their own. After much grumbling about the restrictions associated with this aid, the strongest banks are now back on shore. On June 9th ten banks—nine of which had undergone stress tests in April—were given the go-ahead to repay a combined $68 billion to the Troubled Asset Relief Programme (TARP). Though no list was published, the lucky lenders gleefully advertised their escape. They include three titans—JPMorgan Chase, Goldman Sachs and Morgan Stanley—as well as two regional banks, three custodians and two credit-card issuers.

The move was made possible by a recent market thaw that allowed relatively healthy banks to go on a capital-raising spree. Banks have—for now, at least—amassed enough equity to get by without having to offload their least liquid assets. Plans for a public-private partnership to buy up banks' most troubled loans and securities have been largely put on ice.

We have been here before, say sceptics, only to see fresh capital fizzle as bad assets ate through balance-sheets. If markets tank again, they worry, some of the first repayers may even need a hugely embarrassing second handout. Officials counter that the banks were forced to raise substantially more capital than was required by the stress tests, to ensure an extra-plump cushion, and to show that they could raise at least some debt without government guarantees (albeit at elevated spreads).

The cushion may not be as padded as it looks, however. Also on June 9th, the Congressional Oversight Panel published a report that questioned the stress tests' reliance on banks' own data and their failure to capture the full risks in asset classes, particularly commercial property, that are only now going bad. The panel urged that the tests be repeated, since unemployment is expected to exceed the level envisaged in the worst-case scenario.

There are other reasons to keep the champagne on ice. Even the healthiest banks—including those that

insist they never needed help—continue to rely on government assistance in the form of liquidity facilities, generous collateral rules and the like. The debt-guarantee scheme is due to expire in October but may be extended. Moreover, the TARP escapees have yet to learn the price they must pay to cancel the government's warrants, which give it the right to buy common shares for ten years. JPMorgan Chase alone could have to stump up $2.6 billion, according to CreditSights, a research firm.

The banks are sure to face lots of new red tape, even outside the TARP—and even if, as seems likely, the government scales back the extent of the regulatory overhaul it is expected to unveil on June 17th. Firms considered too big to fail face tougher capital and liquidity rules. Under executive-pay rules set out on June 10th, banks needing multiple bail-outs, such as Citigroup, will fall under a new "special master" who can reject pay plans for senior employees. All TARP banks will be subject to bonus and golden-parachute limits. Those with no government capital will not face specific limits, but shareholders will have more of a say on pay, Congress willing, and regulators more leeway to alter pay policies.

The stragglers are naturally keen to join the first ten on dry land. They fear further stigmatisation now that the wheat has been formally separated from the chaff. A more specific concern is the loss of talent to ex-TARPers. One reason Morgan Stanley worked so hard to ensure its place in the first wave was the stomach-churning prospect of Goldman Sachs poaching its finest.

For those left behind, prospects vary. Wells Fargo (busy digesting Wachovia) and Bank of America (which has been choking on Merrill Lynch and Countrywide) will hope to be in the second wave of repayers, perhaps towards the end of this year.

At Citigroup, which will soon be 34% state-owned, things are even less comfortable. The Federal Deposit Insurance Corporation (FDIC), which is on the hook for $290 billion of Citi's deposits as well as debt guarantees, is said to be unconvinced by Citi's stress test, which identified a $5.5 billion capital hole. It is also pushing for a board and management shake-up to bring in more commercial-banking experience—Citi's boss, Vikram Pandit, and some of his closest lieutenants cut their teeth in capital markets. Other regulators would prefer to leave the former quant to implement his belated turnaround plan. The tussle echoes bigger battles. The FDIC has locked horns with other agencies over who should be the new systemic-risk regulator and who should have authority to wind down failing non-banks.

The repayments will increase available TARP funds to $170 billion, reducing the likelihood of having to ask Congress for more money. Some may be used to pay down debt (or rather, to slow its growth), but Tim Geithner, the treasury secretary, wants to keep a healthy buffer to deal with surprises. He is also keen to "level the playing field" by helping smaller banks, which were largely overlooked during efforts to stabilise the giants. The groundwork has been laid, with the maximum they can request recently raised from 3% to 5% of assets, and the approval process streamlined.

Small banks are just as wary of the TARP stigma as larger rivals. But their woes are growing along with those of commercial property, to which the small fry are particularly exposed. In the very worst case, more than 2,000 community and regional banks—a quarter of the total—could fail or be forced to merge, reckons Institutional Risk Analytics, a research and ratings firm. Quite apart from the cost to the FDIC's deposit-insurance fund, anything close to that would prove logistically overwhelming for regulators. So throwing lifebelts to smaller banks makes sense. But if things take another turn for the worse, the big ones could end up back in the water.

Economist.com FINANCE & ECONOMICS

Buttonwood

Caught short

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From The Economist print edition

Returns may have improved but hedge funds still face a lot of problems

Illustration by S. Kambayashi



THE hedge-fund industry is making money again. Figures from Hedge Fund Research (HFR), a consultancy, show that the average fund gained 5.2% in May, the best monthly performance since 2000. Several sectors have earned double-digit returns so far this year.

The rebound comes after a traumatic 2008 for the industry, during which the average fund lost nearly 19% and there was a wave of redemption demands from investors. Assets under management have fallen by around $600 billion from their peak, leaving the industry with just over $1.3 trillion to look after.

Nearly 1,500 funds were liquidated last year, the population of the entire industry back in 1993. Although some new funds have been created, HFR reckons there were just 8,860 funds at the end of March, down from 10,096 in 2007.

This Darwinian process may have helped those managers who survived. A smaller industry means there is less competition for profitable opportunities. Work by Bill Fung and Narayan Naik of the London Business School shows that one of the best periods for hedge-fund outperformance occurred in the aftermath of the collapse of Long-Term Capital Management in 1998. Then, as recently, market prices moved erratically, creating anomalies to exploit.

Taking advantage of those anomalies proved difficult at the height of the credit crunch. Hedge-fund managers needed to hold cash to meet redemptions. In addition, prime brokers (the main providers of finance to the sector) were restricting the amount that managers could borrow. Now JPMorgan, a leading prime broker, is saying that managers are willing and able to borrow again. Not on the scale seen in 2006, admittedly, but enough to take advantage of rising markets.

Even though returns are recovering, the industry is in a much weakened position. Clients are now suspicious of the fees that hedge funds could command in their glory days. A memo from CalPERS, a huge Californian pension fund, said it would “no longer partner with managers whose fee structures result in a clear misalignment of interest between managers and investors.” In practice, that means phasing performance fees over longer periods and demanding that such fees are only generated when the manager exceeds a hurdle rate of return (not zero, as was often the case).

In addition, many investors are now demanding that hedge funds run assets in “managed accounts”, where their money is held separately and the holdings are transparent. In the boom years, hedge-fund managers could afford to refuse such requests, which they tended to regard as too much hassle.

A further advantage of managed accounts, from the investors’ point of view, is that it is easy for them to withdraw their money. Many investors are smarting from their experiences in 2008, when hedge-fund managers abruptly imposed “gates” to restrict withdrawals. Those funds that did resort to gates are still being punished by investors this year. Figures from HFR show that investors withdrew around $104 billion in the first quarter of the year, which was more than 7% of the industry’s total assets.

The bit of the industry that is suffering most is the funds-of-funds sector. It claims, for an additional fee, to be able to put together a portfolio of the best hedge-fund managers. But this claim was rather dented by the exposure of several leading groups to Bernie Madoff. Funds-of-funds are struggling in 2009 as well: their returns are lagging five percentage points behind the average for the industry.

Funds-of-funds are especially vulnerable to an investor squeeze. The investors who have proved most

disillusioned with the hedge-fund industry have been high-net-worth individuals, who believed all the talk about “absolute returns” and were dismayed by last year’s double-digit losses. That means the industry will become more focused on institutional investors like pension funds and endowments. But these investors can develop their own expertise in picking the best funds or may opt for model-based “clones” that aim to produce hedge-fund-like returns at lower cost.

To add to the industry’s problems, it faces renewed interest from regulators. Managers are particularly exercised by a draft European directive which will impose limits on leverage and greater requirements for transparency, which could limit returns. Among other things, the new rules also require prime brokers to be resident in the same jurisdiction as their clients, a mindless piece of bureaucracy. From being masters of the universe two years ago, hedge-fund managers now fear becoming servants of Brussels.

Economist.com/blogs/Buttonwood

Banks' exposure to eastern Europe

Stand by me

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Western banks have supported their eastern European subsidiaries—so far

WHEN it comes to banking crises, "Latvia on the brink" doesn't really cut the mustard. At worst Western banks and their subsidiaries in the country could faces losses of $10 billion—about the same amount as a typical investment bank wrote off during a bad quarter in 2008. Yet the tiny Baltic state's continuing battle to defend its currency peg cannot be dismissed: it is a reminder of the wall of bad debts faced by banks across central and eastern Europe (CEE), many of which have western European parents (see map).



Contagion is a risk. If Latvia's peg goes, others in the Baltics and beyond may come under pressure, making it harder for those who have borrowed in hard currencies to avoid default. A Western bank could even abandon a local subsidiary, although Mark Young of Fitch, a credit-rating agency, thinks that is pretty unlikely as it would create wider fears among depositors and counterparties about foreign parents' resolve to stand by their CEE operations.

An obvious test-case is the three Swedish banks that dominate lending in the Baltic states. Nordea, SEB and Swedbank own local lenders and, because their loans exceed deposits by a factor of two or more, also extend funding to them. They have prepared for rising losses by issuing a combined €5 billion ($6.9 billion) through rights issues in the past six months, adding almost a fifth to their tier-one capital.

Sweden's central bank and banking supervisor have both recently published the results of stress tests which judge that, in the words of the latter, the system can "withstand extreme pressure". The tests look fairly conservative, assuming loss rates on loans of up to a third in the Baltics and 60% in Ukraine. Tier-one capital ratios in the worst case drop to 6%, about the same level as permitted in America's recent stress tests. For good measure Sweden has in place funding guarantees to help big lenders borrow and has also said it will inject more capital into banks if necessary. On June 10th its central bank borrowed a further €3 billion from the European Central Bank, in order to be able "to provide liquidity assistance" to banks.

Beyond the Baltics, funding from foreign banks to subsidiaries also looks solid. Romania, Serbia and Hungary have extracted commitments from lenders to maintain their exposure. This, along with help from the IMF, has been "an incredibly stabilising factor" for the wider region, says Manfred Wimmer, chief financial officer of Erste Group, an Austrian bank with big eastern European operations.

Experts have long warned against generalising about the region. So far this advice has proven right, with big discrepancies in impairment levels between countries. In the first quarter UniCredit, an Italian bank, recognised bad debts in Ukraine and Kazakhstan equivalent to an annualised rate of about 5% of loans. Yet the number for Poland was just 0.5%, and for its CEE unit overall 1.7%. The same variety typifies the other three Western banks that are most active in the region, KBC of Belgium, and Erste and RZB of Austria.

Bad debts everywhere will soar, however. There will be "serious pressure" on provisioning, says Federico Ghizzoni, who is responsible for UniCredit's CEE operations. Is there enough capital to absorb the losses? Taking UniCredit, KBC, Erste and RZB together, and assuming a 40% loss rate in high-risk countries like the Baltics and Ukraine and a 10% loss rate elsewhere in the CEE region, the hit would eat up about a third of their combined tier-one capital—bad, but not terminal. Again, governments are standing by, having already injected funds into KBC and the Austrian banks. UniCredit is in negotiations to secure a combined €4 billion

capital injection from Italy and Austria. As for funding, these lenders look in a far better position overall than their Swedish counterparts, with a combined loan-to-deposit ratio in CEE of about 115%. RZB has a bigger funding gap but Austria has said it will guarantee up to €75 billion of its banks' borrowings.

The response to the crisis so far, with the IMF providing credit to the neediest eastern European governments and western governments offering support to their banks in the region, seems to have worked. That still leaves banks to work through bad debts and build up their local funding levels. Mr Ghizzoni says there is now "fierce competition for deposits". The spivvy business model of borrowing euros and Swiss francs in the wholesale markets and then ramming them down CEE customers' throats is dead. But the commitment of most western European banks to the region is, if a little grudging, still alive.

Sovereign credit-default swaps

Muffled signals

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Credit derivatives on countries are behaving oddly



GOVERNMENTS in the rich world are announcing record-breaking deficits and their credit ratings are under threat. Yet the market that should be most worried is not. An index of credit-default-swap (CDS) spreads on the seven biggest rich economies maintained by Credit Derivatives Research (CDR), a research outfit, has widened in recent weeks, but still signals half the risk it did in February, before the full scale of the damage to public finances became clear (see chart). The trend holds true even for Britain, which is threatened with a credit-rating downgrade, and Ireland, which on June 8th suffered its second sovereign downgrade in three months.

Dave Klein at CDR admits to being puzzled by the trend. He reckons that investors associate sovereign-default risk with overall financial risk because governments now backstop so much of the system. When America bailed out Fannie Mae and Freddie Mac, the country's two big mortgage agencies, its CDS spreads widened sharply. Conversely, a recovering economy means fewer bank failures, so government balance-sheets are less likely to be strained by bail-outs.

Sovereign CDSs are in any case harder to interpret than corporate CDSs. Rich-country defaults are extremely rare (emerging markets, less so) which makes it difficult for investors to estimate how much they would recover in bankruptcy, a key determinant in CDS pricing. Moreover, payouts on the swaps are triggered in different ways. A corporation generally has a grace period on its debt payments before a credit event is declared and protection is paid off. Governments have no such grace period. If America is 30 seconds late, a credit event is declared, says Mr Klein. Sovereign CDSs also tend be priced in dollars—except for swaps on America's debt, which are priced in euros—so currency risk blurs things too.

Sovereign CDS volumes have held up better than other parts of the market. According to figures from the Depository Trust & Clearing Corporation (DTCC) the number of contracts and the notional value of derivatives on some 60 sovereign borrowers have generally held steady or grown a bit faster than the overall CDS market.

But most of this activity remains concentrated on emerging markets like Turkey, Brazil, Russia and Mexico. For rich countries, the amounts at stake are minuscule. DTCC puts the notional value of CDS contracts on American debt at $9 billion, barely 0.1% of the total amount of publicly held debt. The value of sovereign CDSs is just 6% of all CDSs, according to the Bank for International Settlements. Clues to the rickety state of public finances are better found elsewhere.

America's life-settlement industry

From mortgages to mortality

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Wall Street makes a life-and-death bet

Getty Images

SPECULATING on mortality is a sensitive business. So when a recent conference on the life-settlement industry—which allows global investors to bet on the life expectancy of elderly, ill and preferably rich Americans—was held underneath a Methodist hall in London, one speaker was spooked. "However you think about our industry," he says, "we are waging in death futures. And we were meeting in what seemed like the crypt of a church."

Touchy or not, the industry is in bouncy shape. It is even becoming a magnet for those Wall Street alchemists who brought the world the joys of mortgage-backed securities and credit-default swaps. Now they can wager on death as well as default.

Americans have been free to trade their life-insurance policies since a Supreme Court ruling in 1911. In the 1980s a small market took off when AIDS sufferers were enticed to sell their policies to speculators for cash. More recently, the credit crisis has battered the savings of elderly Americans, leaving their life-insurance policies as one of their more valuable assets. Seduced by advertisements, they can sell it to a life- settlement firm for many times the amount they would get if they cashed it in with the insurer. The buyer takes over payment of the premiums in return for the payout when the policyholder dies.

Although that gives investors a financial interest in the seller's death, it does not, of course, mean Wall Street is about to go around bumping off American pensioners. Rather, the industry believes it can pay more to the policyholders than the life-insurance companies because it has selected those with a high risk of dying soon.

If that sounds morbid, practitioners say it is not much more so than the trading of endowment policies in Britain. But Scott Page, an industry pioneer and chief executive of the Lifeline Program, a life-settlement firm, admits that it is a business full of "headline risk".

That makes it particularly dangerous territory for investment banks. Firms such as Goldman Sachs, Credit Suisse and Deutsche Bank have built big life-settlement desks—one employs about 100 people. Goldman and Credit Suisse have businesses that buy life-insurance policies from individuals. Deutsche Bank prefers to focus on derivative products. This synthetic market is now said to represent about $6 billion-7 billion, compared with a cash market of about $12 billion.

That is still tiny by Wall Street standards but demand is strong. Insurance-linked products, such as catastrophe bonds, are becoming more popular. Investors like the idea that death, like destruction, should be largely uncorrelated with the vagaries of financial markets.

There are pitfalls. Selling the policies is fraught with risks relating to transparency, tax treatment and insurance fraud. In May the Senate's special committee on ageing called for more regulation of the industry. Like so many other "uncorrelated" markets, activity dried up late last year. At the same time, actuaries revised up their life-expectancy tables, battering returns. Litigation is on the rise, especially in grey-haired states like Florida.

As an instigator of the credit crunch, Wall Street is eager to improve not only its profitability but also its stained reputation. Life settlement offers it a chance to do the former. But there is a huge risk to the latter whenever life—and death—is involved.

The sale of BGI

Selling the family silver

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Alamy



Barclays, a British bank, was locked in discussions about the sale of Barclays Global Investors, its fund-management arm, as *The Economist* went to press. The most likely acquirer appeared to be BlackRock, an American fund-management group run by Larry Fink. That would merge one of the world's largest fixed-income investors with BGI's renowned expertise in index-tracking, notably through its iShares business. Other bidders were reportedly in the frame, among them Bank of New York Mellon; Barclays could also still opt for the sale of iShares on its own to a private-equity group. Selling BGI would mean that Barclays would lose one of its most reliable businesses, but it would also allow the bank to raise valuable capital.

The IMF's search for funds

Promises, promises

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Politics influences fulfilment of the G20's funding pledges

MUCH has changed for the IMF as a result of the financial crisis. The G20 summit in London in April promised a tripling of its lending capacity. Long known for championing fiscal stringency, the fund has recommended that Tanzania and Mozambique consider countercyclical fiscal expansions. Mexico, Colombia and Poland have been enticed to sign up for its new precautionary lines of credit. Another first is now well on the way, as the IMF prepares to issue its own bonds.

The bonds have aroused a flurry of interest from emerging markets. The fund announced on June 9th that the Chinese authorities had signalled their intention to invest up to $50 billion in its notes. On June 10th Brazil's finance minister said the country was interested in bonds worth $10 billion. Russia had previously said that it was eyeing a similar amount. According to the fund, the bonds will give emerging economies access to "a safe investment instrument with reasonable return".

As big an attraction, argues Eswar Prasad, a Cornell University professor who once headed the fund's China desk, is that the bonds would count as foreign reserves, allowing emerging economies to exchange one reserve asset for another with no budgetary impact. IMF notes denominated in Special Drawing Rights, the fund's quasi-currency, would provide their buyers with a new way to diversify the composition of a small part of their reserves away from the American dollar. Russia's central bank confirmed on June 10th that it may shift some of its reserves from Treasuries into IMF bonds.

Reuters



Redefining collateral damage

Politics, inevitably, also plays its part. Contributing to the fund gives countries a louder voice in its decision-making. But by choosing to buy bonds, rather than making a more conventional longer-term loan to the IMF, these countries may also be signalling that they want faster progress on a planned overhaul of emerging economies' voting rights within the institution.

Concerns over governance also complicate the picture in the rich world. In America, voting in the House of Representatives on a bill that appended the country's promised $108 billion contribution to the IMF to funding for the country's war efforts in Iraq and Afghanistan has had to be postponed, in spite of strong backing from the White House and the Treasury.

Opposition to the bill comes partly from anti-war Democrats. But Republicans dislike the idea of money being set aside for the IMF to spend on other countries when America has so many economic woes of its own. The idea that IMF funds could end up helping western European banks exposed to eastern Europe is another gripe. The administration is working hard to win over the naysayers on its own side. And bumps in the road are not that surprising. Despite the united front at the G20 bash, multilateralism remains a hard sell when the time comes to stump up.

Paul Krugman's London lectures

Dismal science

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The Nobel laureate speaks on the crisis in the economy and in economics

THE London School of Economics was once so popular among young American scholars that British students used to joke that LSE stood for "Let's See Europe". A distinguished sightseer, Paul Krugman, returned to the LSE on June 8th to give the annual Lionel Robbins memorial lectures. Mr Krugman, who gave the Robbins lectures 21 years ago, tried to answer two big questions in the course of his three talks. Why did economists not foresee calamity? And how will the world economy climb out of recession?

The immediate cause of the crisis, "the mother of all global housing bubbles", was spotted by many economists. That house prices had risen too far was obvious, even if policymakers had seemed less sure. The surprise was that the bursting of the bubble would be so damaging. "I had no idea it would end so badly," said Mr Krugman.

One big blind spot was the financial system. The mistake was to think "a bank had to look like something Jimmy Stewart could run", with rows of tellers taking deposits in a marble-fronted building. In fact a bank is anything that uses short-term borrowing to finance long-term assets that are hard to sell at a push. The shadow banking system was as important to the economy as the ordinary kind, but was far more vulnerable. Its collapse was the modern re-run of the bank failures of the 1930s, said Mr Krugman.

The excess borrowing that did for shadow banks threatens consumers, too. They are scrambling to save more as house prices plunge. Their mortgage debts loom larger because of vanishing inflation. This urge to shore up wealth is self-defeating in aggregate, as it curbs spending and incomes. It also renders conventional monetary policy impotent, as the interest rate that prevents too much saving is below zero.

That creates a role for fiscal policy. If zero interest rates cannot get consumers to spend, then governments must spend instead. That remedy comes from economics so the discipline is not without merit. The trouble is, "the analysis we're using is decades old". It dates back to Keynes, one of the few economists whose reputation has been burnished by the crisis. (Another is Hyman Minsky, whose main insight was that stability leads to too much debt, and then to collapse.) Most work in macroeconomics in the past 30 years has been useless at best and harmful at worst, said Mr Krugman.

As for the economy, the road back to health will be long and painful. The big lesson from past bubbles is that recovery is export-led, which is not helpful "unless we can find another planet to export to". Otherwise, recovery will have to wait for savings to be rebuilt, and that will not happen quickly. Higher inflation than before the crisis might help, he said.

Economics focus

Fatalism v fetishism

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How will developing countries grow after the financial crisis?

Illustration by Jac Depczyk



FORTY years ago Singapore, now home to the world's busiest port, was a forlorn outpost still garrisoned by the British. In 1961 South Korea was less industrialised than the communist north and dependent on American aid. In 1978 China's exports amounted to less than 5% of its GDP. These countries, and many of their neighbours, have since traded their way out of poverty. Given their success, it is easy to forget that some development economists were once prey to "export fatalism". Poor countries, they believed, had little to gain from venturing into the world market. If they tried to expand their exports, they would thwart each other, driving down the price of their commodities.

The financial crisis of the past nine months is stirring a new export fatalism in the minds of some economists. Even after the global economy recovers, developing countries may find it harder to pursue a policy of "export-led growth", which served countries like South Korea so well. Under this strategy, sometimes called "export fetishism", countries spur sales abroad, often by keeping their currencies cheap. Some save the proceeds in foreign-currency reserves, rather than spending them on imports. This strategy is one reason why the developing world's current-account surplus exceeded $700 billion in 2008, as measured by the IMF. In the past, these surpluses were offset by American deficits. But America may now rethink the bargain. This imbalance, whereby foreigners sell their goods to America in exchange for its assets, was one potential cause of the country's financial crisis.

If this global bargain does come unstuck, how should developing countries respond? In a new paper*, Dani Rodrik of Harvard University offers a novel suggestion. He argues that developing countries should continue to promote exportables, but no longer promote exports. What's the difference? An exportable is a good that could be traded across borders, but need not be. Mr Rodrik's recommended policies would help countries make more of these exportables, without selling quite so many abroad.

Countries grow by shifting labour and investment from traditional activities, where productivity is stagnant, to new industries, which abound in economies of scale or opportunities to assimilate better techniques. These new industries usually make exportable goods, such as cotton textiles or toys. But whatever the fetishists believe, there is nothing special about the act of exporting per se, Mr Rodrik argues. For example, companies do not need to venture abroad to feel the bracing sting of international competition. If their products can be traded across borders, then foreign rivals can compete with them at home.

As countries industrialise and diversify, their exports grow, which sometimes results in a trade surplus. These three things tend to go together. But in a statistical “horse race” between the three—industrialisation, exports and exports minus imports—Mr Rodrik finds that it is the growth of tradable, industrial goods, as a share of GDP, that does most of the work.

How do you promote exportables without promoting exports? Cheap currencies will not do the trick. They serve as a subsidy to exports, but also act like a tax on imports. They encourage the production of tradable goods, but discourage their consumption—which is why producers look for buyers abroad.

Policymakers need a different set of tools, Mr Rodrik argues. They should set aside their exchange-rate policies in favour of industrial policy, subsidising promising new industries directly. These sops would expand the production of tradable goods above what the market would dictate. But the subsidy would not discourage their consumption. Indeed, policymakers should allow the country’s exchange rate to strengthen naturally, eliminating any trade surplus. The stronger currency would cost favoured industries some foreign customers. But these firms would still do better overall than under a policy of laissez-faire.

Return of the cargo cult

Mr Rodrik offers a solution to an awkward problem: how policymakers can restore the growth strategies of the pre-crisis era without reviving the trade imbalances that accompanied them. But is his solution as neat as it sounds? Start with the theory. Mr Rodrik claims there is nothing special about exporting. He is probably right. But his statistical test is unlikely to be the last word on the matter, given the difficulties of disentangling variables that move together. Mr Rodrik’s model also assumes a single tradable good. Under his policies, countries sell the same kind of stuff at home that they formerly sold to foreigners. In a more elaborate model, foreign and local tastes would differ. China, for example, made most of the world’s third-generation mobile phones long before 3G telephony was available at home. Firms in poor countries can learn a lot from serving richer customers abroad.

What about the practice? Subsidies are notoriously prone to error and abuse. Even before the crisis, Mr Rodrik was keen to rehabilitate industrial policy in the eyes of many economists, who doubt governments’ ability to pick winners but have every faith in their aptitude for favouring corporate friends. In these circles, a cheap currency is often seen as the least disreputable form of industrial policy, because it benefits exporters in general, without favouring any particular industry or firm.

This ingenious economist may also be preparing for a future that is further off than you might think. American policymakers are certainly worried about their country’s trade deficit. But they are far more concerned about unemployment. Most of their efforts to revive demand will tend to widen the trade gap, at least in the short run. The American government is also more anxious than ever to sell its paper, and whatever they say in public, the central banks of China and other big emerging economies still seem happy to buy. Export fetishism seems fated to endure.

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* “Growth after the Crisis” by Dani Rodrik, May 2009

Solar-powered manned flight

Flying for ever

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A new solar-powered aircraft attempts to fly around the world with zero emissions

Solar Impulse



WHEN an airliner takes off for a transatlantic flight it needs to carry some 80 tonnes of fuel, which accounts for around one-fifth of its weight. On really long flights, fuel can account for 40% of a plane's take-off weight, so that around 20% of the fuel is used to carry the rest of the fuel. Each tonne of fuel burned also produces 3.2 tonnes of carbon dioxide. Yet inside a hanger at a Swiss airfield is the prototype of an aircraft (illustrated above) that does not use any fuel at all. The wings of this aircraft are almost as big as those of an airliner, but they are covered in a film of solar cells that convert sunlight into electricity to drive its engines.

Solar-powered aircraft have flown before. The pioneer was Paul MacCready, whose Gossamer Penguin made the first manned flight in 1980 in California, with his then 13-year-old son at the controls. A derivative, Solar Challenger, crossed the English Channel in 1981. But nothing like HB-SIA, as the Swiss aircraft is known, has ever taken to the air. If it works as expected, another version will be built and this will take off, climb to 10,000 metres and, by storing some of the electricity generated during the day, continue flying through the night. Its pilots, Bertrand Piccard and André Borschberg, plan to cross the Atlantic in it and later to fly it around the world.

The prototype will be unveiled on June 26th by Solar Impulse, a project the aviators run. Mr Piccard helped pilot Orbiter 3, the first balloon to fly non-stop around the world, and comes from a family of adventurers: his grandfather, Auguste, was the first to fly a balloon into the stratosphere and his father, Jacques, plunged to record depths in a bathyscaphe. Mr Borschberg is an engineer and fighter pilot.

Testing to the limit

Although he has flown HB-SIA in a simulator, Mr Borschberg says he will not really know how it performs until the first test flight later this year. The prototype pushes some technologies to their limits, especially in the trade-off between weight and performance. So, although it has a wingspan of 61 metres, HB-SIA has room only for a pilot. It weighs just 1,500 kilograms, making it five times lighter than a high-performance glider would be if made that big.

The complex skeleton of HB-SIA is constructed from carbon-fibre composites formed into honeycomb and sandwich structures. This is covered in plastic film. The film on the upper surfaces of the wings and the

horizontal rear stabilisers is embedded with 12,000 photovoltaic cells. These are capable of converting sunlight into electricity with an efficiency of 22%. Cells with slightly better conversion rates are available, but they are heavier.

A quarter of the weight of HB-SIA is accounted for by its lithium-polymer batteries, which will power the four electrically driven propellers during the first test flights. As those flights become longer and higher, the aircraft will start to draw power from its solar cells. It will fly slowly, only at about 70kph in windless conditions. Its electric motors can produce a maximum of 9 kilowatts, or 12 horsepower—which is about the same as the Wright brothers had. With all four engines at full power, HB-SIA is only as powerful as a motor scooter. Yet with careful rationing of its stored energy, it should be possible to achieve the closest thing yet to perpetual manned flight—with man being the limiting factor because of the need to carry food and drink, and to remain awake for long periods.

If the prototype succeeds in flying through the night then the design of its successor will be finalised. This aircraft, HB-SIB, is intended to operate in stints of around five days and nights. If it succeeds in crossing the Atlantic, it will then try to circle the globe, following the Tropic of Cancer and landing on each continent.

This will involve some daring, with the aircraft spending all day climbing as its batteries are recharged and then descending slowly under power throughout the night to conserve energy. It means keeping a close eye on the weather and navigating around windy areas. The team has experimented with simulated flights using real-time meteorological data. Encountering a headwind at night is a worry. “It could make the night much longer and cause you to run out of energy before sunrise, which would be a disaster,” says Mr Borschberg. Success means a flight plan which ensures that “every morning you are in sunshine”.

A number of companies and groups are sponsoring Solar Impulse, including the International Air Transport Association (IATA). At its annual meeting in Kuala Lumpur this week, the trade group pledged to cap emissions from aviation in 2020. A solar-powered airliner is still a distant dream, but IATA knows that pushing the boundaries of technology will be necessary to help clean up air travel.

Positive thinking's negative results

Words of wisdom

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For some people, optimistic thoughts can do more harm than good

"I CAN pass this exam", "I am a wonderful person and will find love again" and "I am capable and deserve that pay rise" are phrases that students, the broken-hearted and driven employees may repeat to themselves over and over again in the face of adversity. Self-help books through the ages, including Norman Vincent Peale's 1952 classic, "The Power of Positive Thinking", have encouraged people with low self-esteem to make positive self-statements. New research, however, suggests it may do more harm than good.

Since the 1960s psychologists have known that people are more accepting of ideas close to their own views and resistant to those that differ. With regard to self-perception, if a person who believes they are reasonably friendly is told that they are extremely gregarious, they will probably accept the idea. But if told they are socially aloof, the idea will most likely be met with resistance and doubt.

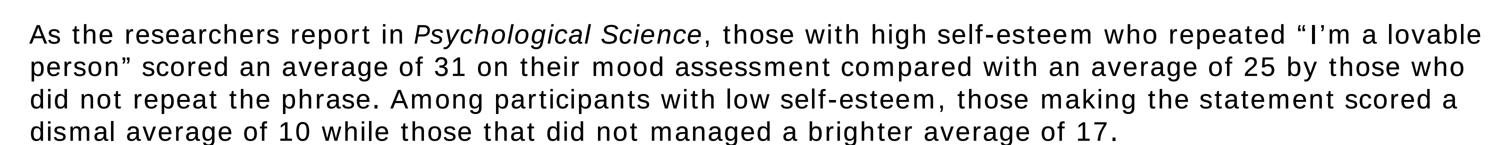
Getty Images



I am important. I am, really

Wondering if the same tendencies could apply to making positive self-statements, Joanne Wood of the University of Waterloo in Canada and her colleagues designed a series of experiments. They questioned a group of 68 men and women using long-accepted methods to measure self-esteem. The participants were then asked to spend four minutes writing down any thoughts and feelings that were on their minds. In the midst of this, half were randomly assigned to say to themselves "I am a lovable person" every time they heard a bell ring.

Immediately after the exercise, they were asked questions such as "What is the probability that a 30-year-old will be involved in a happy, loving romance?" to measure individual moods using a scoring system that ranged from a low of zero to a high of 35. Past studies have indicated that optimistic answers indicate happy moods.



As the researchers report in *Psychological Science*, those with high self-esteem who repeated "I'm a lovable person" scored an average of 31 on their mood assessment compared with an average of 25 by those who did not repeat the phrase. Among participants with low self-esteem, those making the statement scored a dismal average of 10 while those that did not managed a brighter average of 17.

Dr Wood suggests that positive self-statements cause negative moods in people with low self-esteem because they conflict with those people's views of themselves. When positive self-statements strongly conflict with self-perception, she argues, there is not mere resistance but a reinforcing of self-perception. People who view themselves as unlovable find saying that they are so unbelievable that it strengthens their own negative view rather than reversing it. Given that many readers of self-help books that encourage positive self-statements are likely to suffer from low self-esteem, they may be worse than useless.

Drug-resistant infections

Fighting superbugs

Jun 11th 2009
From The Economist print edition

The way a superbug tries to survive might provide a treatment

SUPERBUGS have become the scourge of hospitals worldwide. They have evolved because common bacterial infections developed a resistance to antibiotics. The best-known is methicillin-resistant *Staphylococcus aureus*, known as MRSA. In America the Centres for Disease Control and Prevention says that around 94,000 people get serious MRSA infections each year and 19,000 of them die. Yet around one-third of people carry some form of *S. aureus* without coming to any harm. As researchers come to understand more about the mechanism that keeps some people safe, that knowledge could be used to help those who become ill.

Most people who die from MRSA succumb to the toxic shock that sets in when their immune system goes into overdrive. This is triggered by superantigens, which are powerful toxins produced by the bacteria and which activate a large number of the human immune system's T-cells in the bloodstream. Usually only a small number of these cells are released to hunt down and destroy an infection, with more called up as reinforcements if necessary.

A team led by Joaquin Madrenas of the Robarts Research Institute in London, Ontario, have determined the process by which the superbug can stay in the body without causing harm. In a recent report in *Nature Medicine* they say that the MRSA bacterium seems to have found a way to make itself less harmful to hosts which it has colonised by controlling the toxicity of its superantigens. This has an evolutionary benefit, since *S. aureus* needs living hosts to survive—and if those hosts stay relatively healthy, and keep socialising, then they are likely to infect more people than if the hosts die.

The process involves the cell walls of MRSA, which contain special molecules that bind to certain receptors found on T-cells. This binding process stimulates production of a protein called interleukin-10 (IL-10) that acts as an anti-inflammatory compound and which helps keep the immune system's response to the infection in check. Inflammation is often used by the body to repair tissue (which is why when you sprain a muscle, the area becomes inflamed). Chronic inflammation, however, can be a problem (as in arthritis) and acute inflammation in the form of toxic shock is life-threatening.

It is still not known why the control mechanism breaks down in some people, but the results are very difficult to treat. Dr Madrenas says that understanding the mechanism used by MRSA to keep its host from falling severely ill may ultimately help in finding ways to combat superbugs by mimicking their method of self-preservation. One approach could be to develop drugs that can bind tightly to the receptors on immune cells and induce the production of the anti-inflammatory IL-10. This could help prevent further T-cell activation by the superantigens.

The idea is similar to the way in which an overdose of heroin or morphine is treated. In such cases, drugs such as naloxone and naltrexone provide molecules that bind to opioid receptors with a higher affinity than the opioids themselves, but do not activate the receptors. This blocks the receptors and prevents the body from responding to opiates. The same approach might even provide an antidote in the case of a biological attack, because bioweapons are also likely to rely on superantigens.

Appropriate drugs could, Dr Madrenas speculates, mean that *S. aureus* ultimately becomes a harmless inhabitant of people's bodies. While such drugs are still years away, Dr Madrenas believes that knowing how MRSA colonises human hosts and controls its lethal weapons will eventually make it possible to turn those weapons on the superbugs themselves.

The science of ageing wine

Box clever

Jun 10th 2009
From The Economist print edition

Some wine can improve if stored in a carton rather than in a bottle

AMONG snobs and sommeliers, nothing can compete with wine in a glass bottle sealed with a cork stopper. Yet as cheap alternatives to cork have become available and high fuel prices have made transporting glass more expensive, some winemakers have adopted an alternative method of storage: putting wine in cartons, like those used for milk, made from layers of polythene, paper and aluminium foil. Admittedly, serving wine from a carton lacks the aesthetic appeal of a bottle, and cartons have also been criticised for allowing flavour-destroying oxygen to seep in during storage. A new study, however, reveals that although the criticism of wine cartons for allowing oxidation is valid, they have the advantage of soaking up chemicals that can ruin the flavour in other ways.

High levels of chemicals called alkyl-methoxypyrazines can make wines taste as though the fruit from which they were made was under-ripe or low-quality. Originally grapes themselves were thought to be the only source of this class of compounds in wine, but recent research has shown that invasive Asian lady beetles (also known as Harlequin ladybirds) are also involved in the process. These beetles eat grapes and can accidentally get mixed into the winemaking process. They then contribute to the formation of these undesirable chemicals in some North American and French wines.

The wine industry has tried various ways to remove alkyl-methoxypyrazines, but none has been particularly successful. To make matters worse, the Asian lady beetle is becoming more prevalent in Italy, Spain, Argentina and South Africa, which means winemakers from those regions could soon face the problem of dealing with these chemicals, too. But it has long been known that packaging plays a role in controlling wine chemistry and taste by absorbing some volatile compounds in a process known as "flavour scalping". A team led by Gary Pickering at Brock University in Canada decided to investigate the impact of different forms of packaging on the concentration of alkyl-methoxypyrazines in wines.

The researchers added three types of alkyl-methoxypyrazine to red (cabernet franc) and white (riesling) wines, some of which were stored in cartons, and others in bottles. Natural cork, synthetic cork and screw caps were used to seal the bottles. The researchers then monitored chemical levels in the wines for 18 months.

They report in the *Journal of Agricultural and Food Chemistry* that at the end of the study the levels of the different types of alkyl-methoxypyrazines, known as IBMP, IPMP and SBMP, had fallen by 45%, 32% and 26% respectively in the wines stored in cartons. In wines stored in bottles, the levels of IBMP (which produces a characteristic "sweet pepper" taste) did not fall as much: by 37% for synthetic cork, 36% for screw cap and 31% for natural cork. When it came to IPMP (associated with "green pea" and "earthy" flavours) the level increased by 2-3% for natural cork, but fell by 7% for screw cap and 19% for synthetic cork. The levels of SBMP (which is thought to help determine aroma) rose in all the bottled wine, but fell in that kept in cartons. The results were similar for both types of grape.

Why the cartons have this effect is not entirely understood, but Dr Pickering speculates that the wine may be seeping through the inner polythene layers and making contact with the aluminium layer beyond. He suggests that the alkyl-methoxypyrazine molecules may be sticking to the aluminium and thus being segregated from the wine. If his theory is correct, fiddling with the composition of box interiors could be a good way for the wine industry to control the concentration of unpleasant chemicals.

Cartons might thus assume an important role in the wine market. They could be ideal for storing wines that are inclined to be high in alkyl-methoxypyrazines but will be drunk relatively soon after purchase, before oxidation can become a significant problem. For grand wines, however, bottles with natural corks are likely to remain the packaging of choice.

Anti-mist coatings

Not misty for me

Jun 11th 2009
From The Economist print edition

A new, cheap way to stop glass from fogging

Alamy



TAKE a hot shower and the chances are that the bathroom mirror will mist up. Glasses and camera lenses can also suffer in humid conditions. And it can be dangerous when a car's windscreen clouds over. Various methods, including sprays, materials and heating, have been used with varying degrees of success to deal with the problem. Now a Chinese team has come up with a new idea.

Junhui He of the Chinese Academy of Sciences, Beijing, and his colleagues have created a cheap anti-mist coating. They estimate one square metre of glass will cost only a few cents to treat.

Glass mists up because of sudden condensation when warm, humid air comes into contact with a cold surface. Water vapour condenses to form thousands of tiny water droplets which scatter light. Dr He and his colleagues knew that when certain nanoparticles (which have diameters of only a few billionths of a metre), are spread over glass they break the surface tension of the droplets as they try to form. The result is a thin, transparent film of water which, unlike droplets, does not scatter light.

But what size and shape of nanoparticles is most effective and can be produced cheaply? Dr He's team experimented with different shapes and found a simple one-step method using polystyrene spheres treated with oxygen and then coated with silica to build raspberry-like shapes. These shapes have proved to be the most effective in preventing a surface from misting over. Dr He and his colleagues hope to commercialise the process quickly.

An exhibition of medieval drawings

Images to delight and confound

Jun 11th 2009 | NEW YORK
From The Economist print edition

An intriguing show at the Metropolitan Museum of Art in New York may require art history to be rewritten

The Pierpont Morgan Library NY



PEOPLE have been drawing since they lived in caves, if not before. But in the Western world, drawing as an art is said to have started with the Renaissance. An exhibition, “Pen and Parchment”, at the Metropolitan Museum reveals how incorrect that assumption is. The show, open until August 23rd, is hung with more than 50 finely detailed, beautifully observed and executed medieval drawings, all created between the ninth and 14th centuries.

Although some of these drawings were clearly intended to become paintings (and must therefore be considered unfinished), many were done as complete works of art in themselves. A few stand alone, among them sketches on scraps of parchment, but most are bound into texts with which they have an intricate relationship, literal and metaphorical. Almost all these treasured works are housed in university and monastery libraries where they are seldom seen by outsiders. For these reasons the show, the first of its kind, is a revelation.

The Middle Ages started around 500AD and lasted for 1,000 years. The period had no Giorgio Vasari, the Renaissance artist who publicised the magnificent achievements of his contemporaries; his book, “The Lives of the Artists”, is still widely read. But medieval draftsmen have now gained a passionate champion in Melanie Holcomb, the exhibition’s lead curator. Loans have come from world capitals and from remote monasteries, such as Einsiedeln in Switzerland. The names of most of the artists remain unknown but their work will be seen by tens of thousands.

The drawings, which include a superb design by a 13th-century architect for the façade of Strasbourg cathedral, anatomical diagrams, imaginative astrological compilations, complex battle scenes, saints and lovers as well as sketches of foreign flora, are arranged thematically and chronologically. The main segments are labelled: “Early Medieval Masterpieces”, “Scholarship and Science” and “Tools and Materials”.

The show opens with the early ninth-century Corbie Psalter from France. Ms Holcomb had intended to start with the fifth-century “Corpus Agrimensorum Romanorum”, an illustrated volume about land surveying. However, the Herzog-August Bibliothek in Wolfenbüttel, Germany, (like others holding very early medieval works) would not lend it. This was a disappointment, but the lavishly illustrated Corbie Psalter is the

curator's favourite book. It is, she says, "the first evidence of someone realising the potential of drawing, of what a line can achieve." Every psalm and canticle began with an illustrated initial, 156 of which survive. Through them swirl drawn images of monks (the book's intended readers) as well as birds, biblical figures and fantastical creatures.

Next to it stands another French work, the Four Gospels, produced later in the same century. It displays an arresting, monochrome portrait of the Evangelist Luke, filling almost the whole page (see above). An endearing, small winged ox (Luke's symbol) watches from his perch on a curtain rod as Luke writes his text. Both have gold haloes.

The period's chief masterpiece, the Utrecht Psalter, produced in 830, is represented by a photograph (it rarely leaves the Netherlands and never crosses an ocean). Its 166 often complex ink drawings illustrate passages in the psalms; it is open at a page crowded with images telling the story of Psalm 11. This influential book had arrived in England by 1000, and within a century had become the model for the spectacular Harley Psalter, which has pride of place in the centre of the room. It is the first time that the British Museum has let it travel to America. Its vivacious coloured line drawings were created by eight draftsmen over a period of 100 years.

Two named artists appear near the end of the exhibition. A 13th-century English writer and draftsman, Matthew Paris, is represented by compelling close-up, tinted portrayals of the Virgin and Christ. They are at once familiar and alien, a bridge between his time and our own. Not so a drawing by Opicinus de Canistris. Although created 100 years later, the bridge is gone. It is a large drawing of a body, with a vertical array of smaller men inside it. The catalogue calls it an attempt at self-understanding; viewers may find it stubbornly obscure. Yet in another way it is boldly explicit. The parchment, which has never been cut or smoothed, retains the outline of a sheep, the impression of its spinal column still visible.

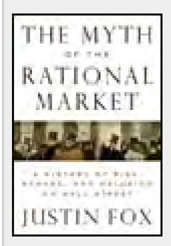
Light levels are low to avoid damaging the drawings. Only three lenders allowed museum staff to open cases and turn pages once a month. The others presumably felt that the risk of tearing or smudges from oily, humid hands (albeit gloved) was an even greater worry than exposing a single precious page to continuous light.

The inefficiency of markets

Slaves to some defunct economist

Jun 11th 2009
From The Economist print edition

The Myth of the Rational Market: A History of Risk, Reward, and Delusion on Wall Street
By Justin Fox



HarperBusiness; 382 pages; $27.99

Buy it at
Amazon.com
Amazon.co.uk

THE financial crisis that has engulfed the world in the past two years is not just, or perhaps even mainly, a tale of greed run riot; it is the result of an idea that failed. That idea, which over the past four decades became the dominant belief among those generally regarded as the savviest participants in the financial system, was that the market is rational and efficient. So much for that.

The idea first took hold among a generation of economists repelled by the heavy government oversight of financial markets imposed during the New Deal era and by evidence of widespread irrational behaviour by participants in these markets. At the same time they were excited by the advances in mathematical economics and the computing power that allowed market data to be analysed like never before.

Justin Fox's description of how the idea evolved and conquered is fascinating and entertainingly told. A statement of investor impotence—an attack on the bold ones ("idiots", said Larry Summers, a distinguished economist) who think they can beat the market—soon became a near-religious belief. Nobel-laureate preachers, such as Milton Friedman and Merton Miller, proclaimed from the pulpits of the University of Chicago that the market could do no wrong.

Somewhere along the way, what started as a critique of the wrong ways people tried to profit from the market turned into a source of new techniques for making money. The "efficient market hypothesis", the Nicene Creed of the market rationalists, inspired a wave of innovative financial products, such as derivatives and securitised subprime mortgages, that believers claimed would allow users to exploit the wonders of the market. This gospel was embraced so enthusiastically by the markets that these products soon accounted for trillions of dollars of trades. Then it turned out that the market was not rational after all. Trillions were wiped out and, as one of the cheerleaders for rationality, Alan Greenspan, the former chairman of the Federal Reserve, put it, "the whole intellectual edifice collapsed."

By then, mainstream academic economists had long ago lost faith in market rationality, at least in its purest form. Especially after two of their number, Myron Scholes and Robert Merton, both Nobel laureates, lost their shirts when Long-Term Capital Management, a hedge fund based on their rational-market ideas, blew up in 1998. Indeed, the focus of academic finance has been shifting for at least 20 years towards theories that address the ways in which markets behave irrationally. To use John Maynard Keynes's phrase, the market participants who in recent years bet trillions on these new efficient-market-inspired financial products were "slaves to some defunct economist".

The only disappointment about "The Myth of the Rational Market" is that it does not say more about how the ideas that shape financial markets will change in response to this catastrophic intellectual failure. But Mr Fox has written a worthy successor to "Capital Ideas", the late Peter Bernstein's 1990s classic on the emergence of the rational-market myth: bang up-to-date; alas, without the happy ending.

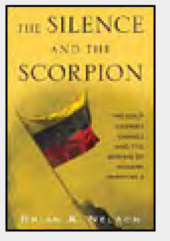
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Venezuela's curious coup

Riddle wrapped in a mystery

Jun 11th 2009
From The Economist print edition

The Silence and the Scorpion: The Coup Against Chávez and the Making of Modern Venezuela
By Brian A. Nelson



Nation Books; 355 pages; $26.95

Buy it at
Amazon.com
Amazon.co.uk

ON APRIL 11th 2002 nearly a million people marched on the presidential palace in Caracas, the capital of Venezuela, to demand the ousting of Hugo Chávez, the elected president whom they accused of undermining democracy and causing the creeping "Cubanisation" of the country. As they neared the palace, violence broke out, 19 people were killed and over 150 wounded. Dramatic video footage aired by an opposition television station appeared to show *chavista* gunmen firing on the unarmed demonstrators. In confused circumstances, the army announced that Mr Chávez had resigned.

Reuters



Chávez's joyous return

The next day Pedro Carmona, the head of the private-business federation, swore himself in as "transitional" president at the head of an ultra-conservative government, and announced the scrapping of the constitution. This prompted riots by supporters of Mr Chávez. Less than 72 hours after he was ousted, the leftist president was restored to power by loyal army units commanded by General Raúl Baduel.

As Brian Nelson, who teaches at Miami University, writes in this superbly researched account, the short-lived coup "would become one of the most important, yet most misunderstood, events in recent history." It severely damaged the democratic credentials of the Venezuelan opposition, while Mr Chávez successfully portrayed himself as the innocent victim of an American-inspired conspiracy to overthrow violently an elected government. He used the failed coup to gain an unassailable grip on the armed forces and, in due course, the previously autonomous state oil company. A precipitate rise in the oil price allowed him to shower public money on social and make-work programmes, restoring his popularity and financing an elected autocracy.

So what really happened in April 2002? Mr Nelson interviewed more than 40 of the main actors, including senior advisers to Mr Chávez, army generals and several of the wounded. From their accounts he has woven a compelling narrative. He concludes that Mr Chávez's brief ouster was "not a coup in the classic sense", nor a premeditated conspiracy, and he exonerates the United States of direct involvement. He finds that the National Guard and *chavista* gunmen started the shooting, and were responsible for most of the bloodshed, though some victims may have been killed when the Caracas police, loyal to an opposition mayor, returned fire.

When Mr Chávez ordered the army to suppress the demonstration, his top generals refused. They rightly argued that the order was unconstitutional. When the television images showed the *chavistas* shedding blood, the president quickly found himself friendless. Though he did not sign a written resignation, he did agree to step down in return for safe passage to Cuba. But the generals failed to broker a constitutional transition. As they dithered, Mr Carmona stepped opportunistically into the power vacuum, staging "a coup within a popular uprising". The army swiftly withdrew its support from the appalling Mr Carmona, making Mr Chávez's return inevitable.

Within days his government began "a multi-million dollar campaign to rewrite the history of the coup". According to Mr Nelson, it destroyed evidence of the killings, blocked all attempts at police and judicial investigation, and swiftly shut down hearings by the *chavista*-controlled National Assembly. It offered

money and benefits to those willing to say they or their relatives had been shot by the opposition, writes Mr Nelson, and harassed those who truthfully claimed the opposite. In this enterprise, Mr Chávez was abetted by foreign admirers, including the Irish makers of an award-winning documentary on the coup which, Mr Nelson finds, contains “many manipulations”.

Those who truly care about human rights may hope that one day Mr Chávez will face trial for his role in the bloodshed of April 11th. Meanwhile, the only ones who were punished are some hapless Caracas policemen, jailed for long terms without evidence. General Baduel, having broken with the president, was arrested last month on corruption charges which he claims are politically motivated. His arrest is part of a wider crackdown on the opposition, intensifying Mr Chávez’s hollowing-out of Venezuelan democracy. This makes Mr Nelson’s scrupulously unbiased account of the events of April 2002 all the more important. It should be read by all those who continue to believe that Mr Chávez is a worthy champion of democracy and the oppressed.

The Silence and the Scorpion: The Coup Against Chávez and the Making of Modern Venezuela.
By Brian A. Nelson.
Nation Books; 355 pages; $26.95

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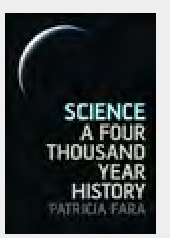
History of science

Crooked path to universal truth

Jun 11th 2009
From The Economist print edition

A CONTROVERSIAL British historian, E.H. Carr, reckoned that his subject was shaped by the very process of studying it. “The belief in a hard core of historical facts existing objectively and independently of the interpretation of the historian is a preposterous fallacy,” he wrote, “but one which it is very hard to eradicate.” Patricia Fara provides a reminder that science is also a human activity.

Science: A Four Thousand Year History
By Patricia Fara



Oxford University Press; 432 pages; $34.95 and £20

Buy it at
Amazon.com
Amazon.co.uk

The birth of science is often dated to 1660, when the Royal Society was founded in London by the followers of Francis Bacon, who argued that knowledge could come only by testing ideas through experiment. Ms Fara, however, points out that they did not start with a blank slate. She places the roots of science back in ancient Babylon, where court advisers developed mathematical and astronomical expertise. Admittedly, these observers were watching the skies in the hope of gleaning future portents. Their observations, however, could be interpreted as scientific because they were trying to correlate what they saw. The fact that they were ultimately unsuccessful, because the movements of heavenly bodies do not determine political events on Earth, does not invalidate the process by which this conclusion was eventually drawn.

The Bridgeman Art Library



What did Vermeer's astronomer discover?

Ms Fara also argues, persuasively, that science is rarely an esoteric effort to attain pure knowledge, as envisaged by Bacon. Rather it stems from attempts to gain power through activities such as politics, magic, religion, trade and war. The Babylonian astronomers were seeking political advantage. The main motive of many Islamic scholars and, indeed, Newton himself, was the better understanding of God. The discovery of America by Christopher Columbus in 1492 unleashed an era of exploration, in which scientific instruments became crucial for navigators. Warfare has long driven science, perhaps most visibly in the development of nuclear weapons.

Because science is done by people, its progress is messy. Sometimes those who shout the loudest are initially accepted as being correct. It takes time for a rival interpretation of results to be accepted as a better explanation. Scientists themselves indulge in political manoeuvring, trying to win funding for their preferred lines of investigation, denigrating their colleagues as they do so. Ms Fara identifies the many cases where the work of various women throughout history has not been credited, and men have claimed the discoveries as their own. Similarly, Chinese inventions have been recast as European and the role of Islamic scholars ignored.

The book romps through history at a terrific rate: from ancient Greece through the Islamic empire of the 13th century, 15th-century China and Renaissance Europe to 20th-century America. It races through ideas: how learned societies emerged, how the theory of evolution affected the way people viewed themselves, how scientific progress brought power to its protagonists. Ms Fara’s informal style helps to speed the pace, but sometimes grates. She also occasionally repeats the same arguments to illustrate different points. Yet the book is so wide-ranging and provocative that these faults can be forgiven.

Scientists like to present their subject as a clear progression from one idea springing from a masterful mind, through its experimental verification to the next ingenious insight; each cool and rational step taken in an orderly fashion. Ms Fara argues that there is no unique path to universal truth. Rather science progresses in fits and starts, with many avenues terminating as blind alleys. Moreover, unlike art, science is

a collective activity that demands collaboration. If Isaac Newton saw farther by standing on the shoulders of giants, then those giants themselves had been standing on the shoulders of others.

Science: A Four Thousand Year History.
By Patricia Fara.
Oxford University Press; 432 pages; $34.95 and £20

Economist.com BOOKS & ARTS

Harold Varmus's life as a scientist

The journey of an inquiring mind

Jun 11th 2009
From The Economist print edition

NEWLY appointed Nobel laureates traditionally give speeches after the banquet held in their honour. In 1989 Harold Varmus, having just received the medicine prize, used his to recall similar Scandinavian revels described in the epic poem “Beowulf”, and to compare his research subject, cancer, to the beast Grendel: a distorted version of our normal selves. Having started out as a graduate student in English literature, his straddling of the worlds of art and science was natural. In the years to follow, he was to go further, encompassing the world of American politics too.

AP



He wounded Grendel

The Art and Politics of Science
By Harold Varmus



Norton; 256 pages; $24.95 and £16.99

Buy it at
Amazon.com
Amazon.co.uk

Mr Varmus divides his autobiography into three phases: the path to science, doing science and being a political scientist. His path was slow: as his graduation neared, he hung a “career decision mobile” from his dormitory ceiling, with applications for graduate study in English, medicine, journalism and more fluttering overhead. Poetry briefly held sway before Columbia medical school drew him away from the humanities.

The next move, from clinical medicine to medical research, was precipitated by the Vietnam war. He avoided the draft by going to work at the National Institutes of Health (NIH). By the time he was 30, he had at last found his subject: how viruses multiply and how they cause cancer. To investigate these questions, which were to occupy him for the next 23 years, he moved to the University of California at San Francisco, where he teamed up with another scientist, Mike Bishop, to form a highly productive partnership. Their joint work was the foundation of the current understanding that genetic mutations are the cause of most cancers.

In a change of direction, Mr Varmus went back to the NIH in 1993 as director. It was a heady time for medical research and he supervised large increases in the agency’s funding. But in his autobiography he has more fun describing the odd challenges a director faces: bizarre committee hearings, cases of scientific fraud and the mushrooming numbers of independent fiefs within the NIH. After six years he moved back to his home turf of cancer, heading the Memorial Sloan-Kettering Cancer Centre in New York. His final chapters describe his work on three controversial subjects: stem cells, global health and the impact of the internet on scientific publishing.

Mr Varmus’s personal tour illustrates how research science is practised in its widest sense, covering both the relationship between science and society, and the nature of the society of scientists. He now co-chairs Barack Obama’s Council of Advisers on Science and Technology—but still finds time to give the occasional poetry reading.

The Art and Politics of Science.
By Harold Varmus.
Norton; 256 pages; $24.95 and £16.99

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Anti-smoking activism

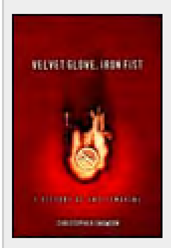
Puff by puff, inch by inch

Jun 11th 2009
From The Economist print edition

Illustration by Daniel Pudles



Velvet Glove, Iron Fist: A History of Anti-Smoking
By Christopher Snowdon



Little Dice; 415 pages; £12.99

Buy it at
Amazon.co.uk

“DON’T forget the cigarettes for Tommy,” ran one patriotic British ditty during the first world war. American generals told their government they needed “tobacco as much as bullets”; charities sent cigarettes to the front-line. After the war, non-smokers seemed odd. The crime writer, Agatha Christie, even apologised for not smoking. She had tried many times, she said, but just could not like it.

In this solidly researched, interesting and only occasionally strident book, Christopher Snowdon, an independent researcher, documents the cigarette’s journey from patriotic necessity to pariah status. There had always been those who found smoking “loathsome to the eye, hateful to the nose, harmful to the brain, dangerous to the lungs,” as James I put it in 1604. Some despots, in Hindustan and Persia, went further, slitting smokers’ lips or pouring molten lead down their throats. American prohibitionists claimed that smoking led to moral decay; Nazis that it was a decadent Jewish habit. But few non-bigots thought that their personal distaste warranted limiting the freedom of others.

Once the awful effects of smoking on health became clear, however, smokers could be harassed for their own good. And the notion of passive smoking allowed campaigners to go even further, and seek to stamp out smoking almost everywhere. In America, lawyers got involved. “Flies to honey, vampires to blood—but we’ve got a glut of lawyers out there just looking for someone to sue,” said John Banzhaf, the founder of ASH, an anti-smoking group. The Master Settlement Agreement of 1997, which cost tobacco firms $246 billion, much of it to be spent on anti-smoking measures, meant that after decades of barefaced lying, Big Tobacco found itself outspent and outmanoeuvred.

Campaigners shamelessly ramped up the evidence that the vice harmed others, and attacked anyone who said otherwise. “The effect of other people smoking in my presence is so small it doesn’t worry me,” declared Sir Richard Doll, who with Sir Austin Bradford Hill had proved in the 1950s that smokers were killing themselves. Anti-smoking activists dismissed the eminent scientist as a crank and a tool of the tobacco industry.

“No one is seriously talking about a complete ban on smoking in pubs and restaurants,” said the director of ASH (UK) in 1998, adding that the suggestion was a “scaremongering story by a tobacco front group.” In June 2005 Britain’s public-health minister described talk of such a ban as “false speculation”. Parliament voted it into law just eight months later. Even then campaigners called for further illiberalism, citing everything from litter to toxins from cigarette butts leaching into groundwater and the harm smoking allegedly does to birds.

Other activists now follow anti-smokers' lead. Flying, drinking bottled water, wearing perfume and burning wood have all been called "the new smoking"; terms like "passive obesity" and "second-hand drinking" do the rounds. "Today it's smoking. Will high-fat foods be next?" asked a tobacco firm in an advertisement in the 1990s. No doubt the ad seemed ridiculously alarmist at the time.

Velvet Glove, Iron Fist: A History of Anti-Smoking.
By Christopher Snowdon.
Little Dice; 415 pages; £12.99



Danny La Rue

Jun 11th 2009
From The Economist print edition

Daniel Carroll (Danny La Rue), female impersonator, died on May 31st, aged 81





HE WAS tall, dark and handsome, with broad shoulders and a crushing handshake. His turned-up nose once annoyed him so much that for a while he slept with a peg on it. He could growl “Ol’ Man River” like Harry Belafonte, and once defended the honour of Barbara Windsor, a well-endowed Cockney comedienne, by socking a man on the jaw. On board ship, no storm ever bothered him; he was practical and calm, even when pianos toppled and chinaware smashed all round him.

She was tall and handsome also, but there the resemblance ended. Her hair was blonde, brunette, raven-black, silver minx, as the mood took her. However coiffed, she looked stunning. Fabulous loops of glitter-beading hung from her arms; sun-bursts of diamanté snaked round her hips; fluorescent feather-boas kissed her neck. One day she was Marlene Dietrich in a silver sheath, the next Joan Collins in a deep blue gown, the next Carmen Miranda, in nine-inch platform shoes and with three tons of fruit on her head. She was probably never more herself than when descending the grand staircase at London’s Palace Theatre, where she played for two unbroken years, with huge pink plumes bobbing on her head and 20 feet of ostrich feathers slithering behind her.

He was well-mannered and rather shy, schooled in respect by his Irish mother and reinforced in fatalism by his fervent Catholic faith. Hard work was his cardinal virtue; in 50 years of cabaret, theatre and music hall he never missed a show. She was a lady of leisure who, under her inimitable elegance, could be lewd, rude and blue. He called her a tart, which she was. In fact, a whole array of tarts: Nell Gywnne, Lady Hamilton, Cleopatra (to tiny Ronnie Corbett’s Caesar). She was Lady Cynthia Grope, political hostess (“Life’s better under the Tories, and I should know”), as well as “the girl with a little bit more”. Nudge, wink. What she could never be was ugly, clumsy, or just a man in drag.

His beginnings were clear enough: born in Cork, brought up in Soho, undistinguished schooldays, a wartime in the navy. Hers were more misty. She emerged in Juliet at school, with a costume of coloured crepe paper, and then in a navy production of “White Cargo”, a pouting beauty wearing nothing but a tan and a sheet she had pinched from the officers’ quarters. Once out in public, she caused a sensation. Bob Hope called her the most glamorous woman in the world. Ingrid Bergman said no one could walk down a staircase like her. From 1964 to 1973 her allure alone packed out his night club in Hanover Square with

Hollywood stars and the crowned heads of Europe. Women deluged her with requests for advice on how to move, how to stand and what to do with their hands. Every woman longed to look like her (he said), but didn't dare.

In certain ways, their characters coincided. Both knew they were stars, no question. Both adored clothes. As a child, he once laid newspaper down the street to keep his new shoes clean. In the navy, lined up on his ship with 1,199 other seamen in pure white, he affected navy and white because it looked nicer. He could happily have stayed as a window-dresser at J.V. Hutton's General Outfitters (Exeter and London), but the limelight called him, as it did her.

Lace and jockstraps

Looking fabulous was all her money was for. A cool £10,000 was budgeted for her frocks at the Palace, and £30,000 when she played Widow Twankey in "Aladdin". One mirrored train cost £7,000; one wrap involved £8,500-worth of fox-fur. He spent his earnings on houses, a stately home with 76 bedrooms, a Rolls Royce and fine porcelain. Fire, and a fraud into which he innocently stumbled in 1983, destroyed almost all he had saved for. He started again, doggedly doing the rounds of clubs, pier-ends and provincial theatres, the outposts of a disappearing world.

Over half an hour each night in the dressing room, he slowly became her. First, a shave (the face only, leaving a touch of stubble for shading; his legs he left alone). Then the pan make-up, powder on face and eyes, mascara and false lashes. Her foam-rubber bosoms were built into each dress; more pan-stick painted a cleavage. "I can hang my tits up when it's hot!" she once boasted to another envious girl. Last came the wig, made especially for her.

He allowed no one else to see this process. He was still Dan, and she was "whoever"; they were always two. Under her lace and glitz, he wore a jockstrap. When she was ready, resplendent in her glitter and feathers, Dan said his prayers and let her sail out of the wings. At the end of the show, he locked the frocks and wigs away. To appear in them off-stage, with a pint grasped in his manly hand, would destroy the vision of woman he had created.

He never married. He said he regretted it, and talked of near-misses that never seemed too convincing. There was already more than enough femininity in his life. His manager, Jack Hanson, was all the close companionship he needed. He shuddered at camp, and at men who wanted to be women or wear women's clothes. Not he; his act was just a wonderful, glamorous, beautiful, elegant joke.

He was the person, he always said. She was the illusion. In practice, it didn't seem quite as simple as that.

Overview

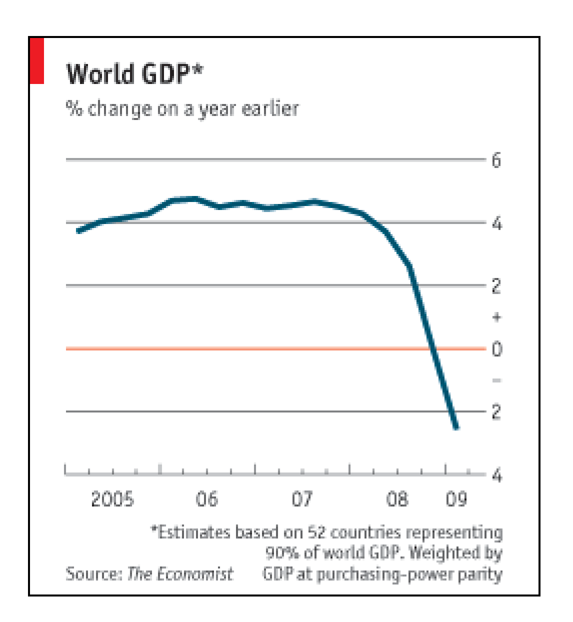
Jun 11th 2009
From The Economist print edition

The unemployment rate in **America** rose from 8.9% to 9.4% in May. Although American employers, excluding farms, cut 345,000 jobs from their payrolls in May, it was the smallest reduction in eight months.

There was mixed news for industry across Europe. Britain's **industrial production** rose by 0.3% in April, the first monthly increase in 14 months. In Italy industrial output rose by 1.1% in the month. In France it fell by 1.4% and in Germany by 1.9%. Sweden's industrial production fell by 2.1%.

Brazil's GDP fell by 0.8% in the first quarter leaving it 1.8% lower than a year earlier.

Consumer prices in **China** fell by 1.4% in the year to May.







Output, prices and jobs

Jun 11th 2009
From The Economist print edition

Output, prices and jobs

% change on year ago

	Gross domestic product				Industrial production	Consumer prices			Unemployment
	latest	qtr*	2009†	2010†	latest	latest	year ago	2009†	rate‡, %
United States	−2.5 Q1	−5.7	−2.8	+1.6	−12.5 Apr	−0.7 Apr	+3.9	−0.8	9.4 May
Japan	−8.8 Q1	−14.2	−6.7	+0.8	−31.2 Apr	−0.1 Apr	+0.8	−1.1	5.0 Apr
China	+6.1 Q1	na	+6.5	+7.3	+8.9 May	−1.4 May	+7.7	−0.5	9.0 2008
Britain	−4.1 Q1	−7.4	−3.7	+0.6	−12.3 Apr	+2.3 Apr§	+3.0	+1.5	7.1 Mar††
Canada	−2.1 Q1	−5.4	−2.3	+1.7	−8.4 Mar	+0.4 Apr	+1.7	+0.3	8.4 May
Euro area	−4.8 Q1	−9.7	−4.1	+0.5	−20.2 Mar	nil May	+3.7	+0.4	9.2 Apr
Austria	−3.5 Q1	−10.6	−2.6	+0.2	−14.3 Mar	+0.7 Apr	+3.3	+0.5	4.2 Apr
Belgium	−3.0 Q1	−6.2	−3.3	+0.2	−18.6 Feb	−0.4 May	+5.2	+0.5	11.2 Feb‡‡
France	−3.2 Q1	−4.7	−2.8	+0.5	−18.8 Apr	+0.1 Apr	+3.0	+0.2	8.9 Apr
Germany	−6.9 Q1	−14.4	−5.5	+0.5	−21.6 Apr	nil May	+3.0	+0.2	8.3 Apr
Greece	+0.3 Q1	−4.6	−3.1	−0.7	−11.7 Apr	+0.5 May	+4.9	+0.4	9.2 Mar
Italy	−6.0 Q1	−10.1	−4.4	+0.3	−24.2 Apr	+0.9 May	+3.6	+0.7	6.9 Q4
Netherlands	−4.5 Q1	−10.7	−3.9	+0.5	−13.2 Apr	+1.6 May	+2.3	+0.9	4.4 Apr††
Spain	−3.0 Q1	−7.4	−3.5	−0.5	−28.6 Apr	−0.9 May	+4.6	−0.1	18.1 Apr
Czech Republic	−3.4 Q1	−12.9	−3.0	+1.2	−23.2 Apr	+1.3 May	+6.8	+1.9	7.9 May
Denmark	−3.7 Q4	−7.3	−3.5	+0.5	−15.0 Apr†††	+1.3 May	+3.4	+1.0	3.3 Apr
Hungary	−6.7 Q1	−9.6	−6.0	−1.0	−25.3 Apr	+3.8 May	+7.0	+3.0	9.9 Apr††
Norway	+1.5 Q1	−1.8	−2.0	+0.5	−4.0 Apr	+3.0 May	+3.1	+2.0	3.2 Mar***
Poland	+0.8 Q1	na	−0.8	+1.5	−12.4 Apr	+4.0 Apr	+4.0	+2.5	11.0 Apr††
Russia	−9.5 Q1	na	−5.0	+2.0	−16.9 Apr	+12.3 May	+15.1	+13.6	10.2 Apr‡‡
Sweden	−6.5 Q1	−3.6	−4.6	+0.9	−21.2 Apr	−0.4 May	+4.0	−0.4	8.3 Apr‡‡
Switzerland	−2.4 Q1	−16.0	−2.3	+0.3	−6.0 Q4	−1.0 May	+2.9	−0.5	3.5 May
Turkey	−6.2 Q4	na	−4.5	+1.2	−18.5 Apr	+5.2 May	+10.7	+6.2	16.1 Q1‡‡
Australia	+0.4 Q1	+1.5	−0.8	+1.6	−0.7 Q4	+2.5 Q1	+4.2	+1.8	5.7 May
Hong Kong	−7.8 Q1	−16.1	−6.7	+0.9	−10.3 Q4	+0.6 Apr	+5.4	+1.0	5.3 Apr††
India	+5.8 Q1	na	+5.0	+6.4	−2.3 Mar	+8.7 Apr	+7.8	+5.0	6.8 2008
Indonesia	+4.4 Q1	na	+2.4	+3.2	+1.6 Mar	+3.8 May	+10.4	+3.9	8.4 Aug
Malaysia	−6.2 Q1	na	−3.0	+1.2	−11.5 Apr	+3.0 Apr	+3.0	−0.4	3.0 Q4
Pakistan	+5.8 2008**	na	−0.9	+2.0	−20.6 Mar	+14.4 May	+19.3	+12.6	5.6 2007
Singapore	−10.1 Q1	−14.6	−8.8	+1.0	−0.5 Apr	−0.7 Apr	+7.5	−0.2	3.2 Q1
South Korea	−4.2 Q1	+0.5	−5.0	+0.6	−8.2 Apr	+2.7 May	+4.9	+1.6	3.9 May
Taiwan	−10.2 Q1	na	−6.5	+0.4	−19.5 Apr	−0.1 May	+3.7	−1.3	5.8 Apr
Thailand	−7.1 Q1	−7.3	−4.4	+1.1	−9.7 Apr	−3.3 May	+7.6	−1.1	1.9 Mar
Argentina	+4.9 Q4	−1.2	−3.5	+0.5	−1.2 Apr	+5.7 Apr	+8.9	+7.0	8.4 Q1††
Brazil	−1.8 Q1	−3.3	−1.5	+2.7	−14.8 Apr	+5.5 Apr	+5.0	+4.4	8.9 Apr‡‡
Chile	−2.1 Q1	−2.4	−1.0	+2.0	−11.1 Apr	+3.0 May	+8.9	+2.4	9.8 Apr††‡‡
Colombia	−0.7 Q4	−4.1	−2.0	+1.8	+0.4 Mar	+4.8 May	+6.4	+5.2	12.0 Mar††
Mexico	−8.2 Q1	−21.5	−4.4	+1.2	−6.7 Mar	+6.0 May	+4.9	+5.1	5.3 Apr‡‡
Venezuela	+0.3 Q1	na	−5.5	−5.4	−0.9 Jan	+27.7 May	+31.4	+30.3	8.1 Q1‡‡
Egypt	+4.3 Q1	na	+3.4	+3.1	+5.7 Q4	+10.2 May	+19.7	+9.1	9.4 Q1‡‡
Israel	+1.1 Q1	−3.6	−0.9	+2.0	−7.7 Mar	+3.1 Apr	+4.7	+1.5	7.6 Q1
Saudi Arabia	+4.2 2008	na	−1.0	+3.3	na	+5.2 Apr	+9.2	+4.3	na
South Africa	−1.3 Q1	−6.4	−1.8	+3.1	+8.5 Mar	+8.4 Apr	+11.1	+6.6	23.5 Mar‡‡
MORE COUNTRIES Data for the countries below are not provided in printed editions of *The Economist*									
Estonia	−15.1 Q1	na	−10.0	−2.5	−33.7 Apr	−0.3 May	+11.3	+0.4	11.1 Mar
Finland	−7.6 Q1	−10.3	−5.7	−1.1	−16.5 Mar	+0.8 Apr	+3.6	+0.3	8.2 Apr
Iceland	−3.9 Q1	−13.6	−12.1	−0.7	+10.1 2008	+11.6 May	+12.3	+12.5	9.1 Apr‡‡
Ireland	−7.5 Q4	−25.7	−7.5	−2.8	−6.7 Mar	−3.5 Apr	+4.3	−3.5	11.8 May
Latvia	−18.0 Q1	na	−15.0	−4.0	−16.9 Apr	+6.4 Apr	+17.4	+2.5	16.1 Mar
Lithuania	−13.6 Q1	−35.8	−13.0	−4.5	na May	+5.2 May	+12.0	+5.0	8.7 Apr‡‡
Luxembourg	−5.2 Q4	−16.8	−5.0	−0.9	−36.1 Feb	+0.3 Apr	+3.5	+0.5	5.5 Mar‡‡
New Zealand	−2.3 Q4	−2.3	−2.7	+0.6	−7.2 Q4	+3.0 Q1	+3.4	+1.4	5.0 Q1
Peru	+3.0 Mar	na	+1.3	+2.5	−7.4 Feb	+4.2 May	+5.4	+4.1	9.3 Mar‡‡
Philippines	+0.4 Q1	−8.9	−1.8	+2.3	−12.7 Mar	+3.3 May	+9.5	+2.9	7.7 Q1‡‡
Portugal	−3.7 Q1	−6.2	−4.0	−0.3	−7.6 Mar	−0.5 Apr	+2.5	−0.7	8.9 Q1††
Slovakia	−5.6 Q1	na	−4.0	+0.7	−24.8 Apr	+2.2 May	+4.6	+1.5	10.9 Apr‡‡
Slovenia	−8.5 Q1	nil	−4.0	+0.5	−24.9 Apr	+0.7 May	+6.4	+1.2	8.4 Mar‡‡
Ukraine	+6.9 Q3	na	−10.0	+1.0	−31.8 Apr	+15.6 Apr	+30.2	+16.5	2.9 Apr
Vietnam	+5.5 Q4	na	+1.6	+4.0	+5.4 Apr	+9.2 Apr	+21.4	+5.4	4.6 2007

*% change on previous quarter, annual rate. †The Economist poll or Economist Intelligence Unit estimate/forecast. ‡National definitions. §RPI inflation rate −1.2 in Apr. **Year ending June. ††Latest three months. ‡‡Not seasonally adjusted. ***Centred 3-month average †††New series

Sources: National statistics offices and central banks; Thomson Datastream; Reuters; Centre for Monitoring Indian Economy; OECD; ECB



The Economist commodity-price index

Jun 11th 2009
From The Economist print edition

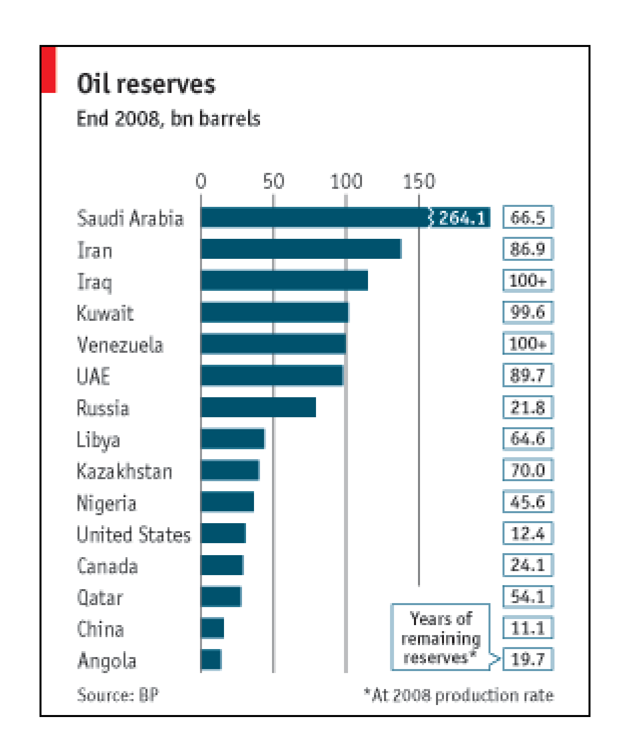
***The Economist* commodity-price index**
2000=100

	Jun 2nd	Jun 9th*	% change on one month	% change on one year
Dollar index				
All items	191.8	190.9	+5.1	-25.6
Food	220.1	216.6	+4.9	-17.5
Industrials				
All	155.1	157.7	+5.5	-36.7
Nfa†	134.7	130.6	+0.6	-35.1
Metals	166.3	172.5	+7.6	-37.4
Sterling index				
All items	175.6	177.9	-1.4	-10.8
Euro index				
All items	124.0	126.1	+2.4	-17.8
Gold				
$ per oz	982.00	951.05	+3.4	+9.1
West Texas Intermediate				
$ per barrel	68.58	69.96	+18.9	-46.9

*Provisional †Non-food agriculturals

Oil reserves

Jun 11th 2009
From The Economist print edition



Although the price of oil peaked at $147 a barrel in 2008, the world's proven oil reserves—those that are known and recoverable with existing technology—fell only slightly, to 1,258 billion barrels, according to BP, a British oil company. That is 18% higher than in 1998. OPEC tightened its grip slightly in 2008, and commands slightly more than three-quarters of proven reserves. Saudi Arabia and Iran together account for almost one-third of the total. Venezuela, with nearly 8%, has the largest share of any non-Middle Eastern country. BP reckons that if the world continues to produce oil at the same rate as last year, global supplies will last another 42 years, even if no more oil reserves are found.





Trade, exchange rates, budget balances and interest rates

Jun 11th 2009
From The Economist print edition

Trade, exchange rates, budget balances and interest rates

	Trade balance* latest 12 months, $bn	Current-account balance latest 12 months, $bn	Current-account balance % of GDP 2009†	Currency units, per $ Jun 10th	Currency units, per $ year ago	Budget balance % of GDP 2009†	Interest rates, % 3-month latest	Interest rates, % 10-year gov't bonds, latest
United States	-730.4 Mar	-673.3 Q4	-3.2	-	-	-13.2	0.32	3.93
Japan	+10.0 Mar	+111.1 Apr	+1.7	98.1	107	-5.7	0.45	1.53
China	+293.9 May	+400.7 Q2	+7.4	6.83	6.92	-3.8	1.23	3.40
Britain	-150.6 Apr	-44.6 Q4	-1.6	0.61	0.51	-13.8	1.30	3.91
Canada	+32.7 Mar	-3.9 Q1	-1.9	1.11	1.02	-2.3	0.23	3.77
Euro area	-56.8 Mar	-145.2 Mar	-1.0	0.71	0.64	-5.8	1.28	3.67
Austria	-4.2 Mar	+15.0 Q4	+1.7	0.71	0.64	-4.6	1.28	4.44
Belgium	+5.0 Feb	-12.1 Dec	-1.8	0.71	0.64	-4.4	1.30	4.23
France	-78.6 Apr	-53.6 Mar	-2.2	0.71	0.64	-6.6	1.28	3.99
Germany	+205.8 Apr	+170.6 Apr	+4.4	0.71	0.64	-4.4	1.28	3.67
Greece	-61.1 Feb	-46.7 Mar	-8.8	0.71	0.64	-6.0	1.28	5.51
Italy	-14.9 Mar	-70.6 Mar	-2.6	0.71	0.64	-5.3	1.28	4.71
Netherlands	+47.6 Mar	+65.3 Q4	+5.9	0.71	0.64	-4.1	1.28	4.06
Spain	-117.2 Mar	+135.9 Mar	-7.5	0.71	0.64	-9.6	1.28	4.32
Czech Republic	+4.1 Apr	-7.2 Mar	-2.1	19.1	15.7	-4.0	2.19	5.75
Denmark	+7.0 Mar	+7.5 Apr	+1.0	5.32	4.80	-2.5	2.40	4.05
Hungary	+0.6 Apr	-13.0 Q4	-3.0	200	159	-2.9	9.67	10.15
Norway	+70.1 Apr	+79.6 Q1	+10.5	6.36	5.15	10.5	2.18	4.31
Poland	-20.2 Mar	-22.0 Mar	-5.2	3.21	2.18	-3.8	4.62	6.29
Russia	+142.3 Apr	+75.4 Q1	-0.6	30.9	23.7	-8.4	11.50	10.24
Sweden	+13.1 Apr	+31.4 Q1	+7.3	7.65	6.03	-4.7	0.34	3.75
Switzerland	+18.0 Apr	+53.3 Q4	+7.6	1.08	1.03	-3.1	0.40	2.44
Turkey	-54.2 Apr	-26.7 Apr	-1.3	1.54	1.26	-5.3	10.91	6.69‡
Australia	+6.1 Apr	-29.8 Q1	-4.7	1.24	1.06	-3.3	3.25	5.60
Hong Kong	-23.8 Apr	+30.5 Q4	+7.8	7.75	7.81	-4.3	0.36	2.87
India	-104.9 Apr	-37.5 Q4	-3.4	47.3	42.9	-7.3	3.35	7.35
Indonesia	+10.4 Apr	-0.8 Q1	+0.5	10,023	9,305	-3.2	7.64	7.50‡
Malaysia	+41.7 Apr	+39.1 Q4	+11.5	3.50	3.27	-8.2	2.09	3.08‡
Pakistan	-17.0 May	-15.3 Q4	-1.2	81.0	67.1	-5.6	13.43	15.42‡
Singapore	+17.1 Apr	+23.1 Q1	+17.2	1.45	1.37	-4.1	0.48	2.45
South Korea	+7.5 May	+13.2 Apr	+1.2	1,247	1,030	-5.6	2.41	5.19
Taiwan	+12.3 May	+29.2 Q1	+9.7	32.7	30.4	-5.0	0.85	1.49
Thailand	+9.9 Apr	+7.9 Apr	+2.7	34.1	33.1	-4.7	1.35	3.46
Argentina	+14.4 Apr	+7.6 Q4	+2.0	3.76	3.06	-0.9	14.63	na
Brazil	+25.6 May	-19.8 Apr	-1.2	1.95	1.65	-2.0	10.16	6.16‡
Chile	+4.0 May	-3.4 Q4	-1.8	565	486	-3.3	1.56	3.41‡
Colombia	+2.1 Feb	-6.8 Q4	-3.9	2,040	1,704	-3.4	5.70	6.30‡
Mexico	-16.2 Apr	-14.2 Q1	-3.1	13.7	10.4	-5.3	5.10	8.20
Venezuela	+32.5 Q1	+26.2 Q1	nil	6.56	3.35§	-7.8	16.00	6.55‡
Egypt	-26.8 Q4	-1.3 Q4	-0.8	5.60	5.36	-7.0	10.32	3.25‡
Israel	-10.8 Apr	+1.6 Q4	+2.0	3.93	3.40	-5.8	0.32	4.43
Saudi Arabia	+197.4 2008	+124.0 2008	-8.4	3.75	3.75	-9.0	0.84	na
South Africa	-6.2 Apr	-21.0 Q4	-5.6	8.06	8.03	-4.0	7.38	8.92
MORE COUNTRIES Data for the countries below are not provided in printed editions of *The Economist*								
Estonia	-2.7 Apr	-1.6 Mar	-3.0	11.2	10.1	-3.5	6.00	na
Finland	+7.5 Mar	+2.5 Mar	+0.6	0.71	0.64	-2.6	1.26	4.09
Iceland	+0.3 May	-6.1 Q1	+2.4	128	77.6	-12.0	7.88	na
Ireland	+45.9 Mar	-12.7 Q4	-2.6	0.71	0.64	-12.5	1.28	5.71
Latvia	-4.6 Apr	-3.0 Mar	-2.0	0.50	0.45	-8.0	15.96	na
Lithuania	-4.8 Apr	-3.6 Mar	-4.0	2.47	2.22	-2.7	8.18	na
Luxembourg	-7.5 Mar	+3.0 Q4	na	0.71	0.64	-3.5	1.28	na
New Zealand	-2.9 Apr	-11.3 Q4	-6.6	1.59	1.32	-6.2	3.55	5.95
Peru	+1.8 Apr	-3.8 Q1	-5.5	2.98	2.88	-1.6	2.98	na
Philippines	-7.2 Mar	+4.2 Dec	+2.3	47.5	44.5	-2.8	3.81	na
Portugal	-31.6 Mar	-27.0 Mar	-9.9	0.71	0.64	-6.0	1.28	4.57
Slovakia	-0.1 Apr	-6.0 Mar	-6.3	21.5	19.5	-4.5	1.35	5.03
Slovenia	-3.8 Apr	-2.4 Mar	-3.5	0.71	0.64	-3.7	1.28	na
Ukraine	-13.4 Q1	-9.8 Q1	-0.3	7.61	4.72	-4.3	10.50	na
Vietnam	-5.4 May	-7.0 2007	-0.5	17,788	16,624	-8.2	8.02	7.07

*Merchandise trade only. †The Economist poll or Economist Intelligence Unit forecast. ‡Dollar-denominated bonds. §Unofficial exchange rate.




Markets

Jun 11th 2009
From The Economist print edition

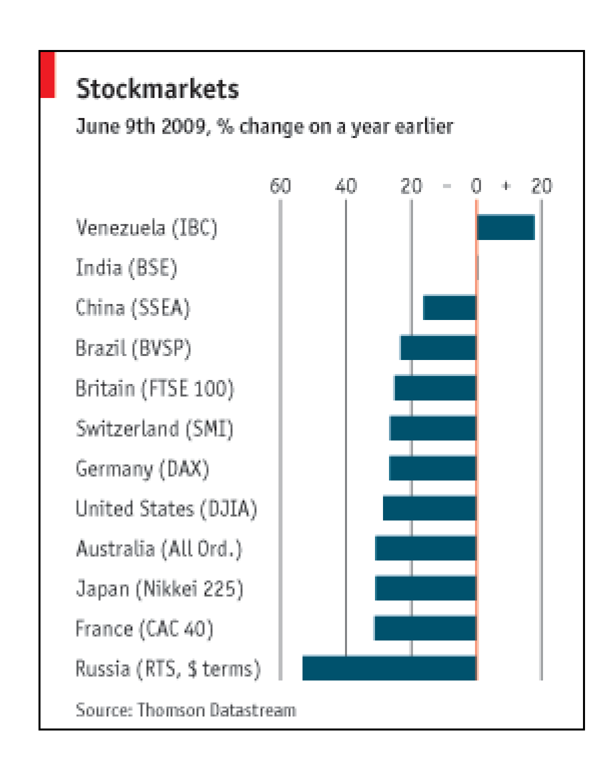
Markets

	Index	% change on		
			Dec 31st 2008	
	Index Jun 10th	one week	in local currency	in $ terms
United States (DJIA)	8,739.0	+0.7	−0.4	−0.4
United States (S&P 500)	939.2	+0.8	+4.0	+4.0
United States (NAScomp)	1,853.1	+1.5	+17.5	+17.5
Japan (Nikkei 225)	9,991.5	+2.6	+12.8	+4.2
Japan (Topix)	937.0	+2.5	+9.1	+0.7
China (SSEA)	2,956.2	+1.4	+54.6	+54.4
China (SSEB, $ terms)	184.0	+1.6	+66.1	+65.9
Britain (FTSE 100)	4,436.8	+1.2	+0.1	+13.9
Canada (S&P TSX)	10,598.0	+3.0	+17.9	+31.1
Euro area (FTSE Euro 100)	771.5	+0.7	+3.4	+4.2
Euro area (DJ STOXX 50)	2,500.9	+0.7	+2.2	+3.0
Austria (ATX)	2,189.1	+2.4	+25.0	+26.0
Belgium (Bel 20)	2,064.3	−0.1	+8.2	+9.0
France (CAC 40)	3,315.3	+0.2	+3.0	+3.8
Germany (DAX)*	5,051.2	−0.1	+5.0	+5.8
Greece (Athex Comp)	2,376.1	−1.4	+33.0	+34.0
Italy (S&P/MIB)	20,299.0	+0.9	+4.3	+5.1
Netherlands (AEX)	267.0	+1.0	+8.5	+9.4
Spain (Madrid SE)	996.8	+1.8	+2.1	+2.9
Czech Republic (PX)	969.2	+4.9	+12.9	+14.1
Denmark (OMXCB)	278.6	+2.6	+23.2	+24.1
Hungary (BUX)	16,594.6	+9.2	+35.6	+29.9
Norway (OSEAX)	356.1	+3.6	+31.8	+45.0
Poland (WIG)	31,916.7	+2.9	+17.2	+8.2
Russia (RTS, $ terms)	1,121.8	−0.5	+79.9	+77.5
Sweden (OMXS30)†	787.1	+2.1	+18.8	+22.8
Switzerland (SMI)	5,436.4	+1.0	−1.8	−3.3
Turkey (ISE)	34,389.3	−1.6	+28.0	+27.9
Australia (All Ord.)	4,016.3	+0.2	+9.8	+24.8
Hong Kong (Hang Seng)	18,785.7	+1.1	+30.6	+30.6
India (BSE)	15,466.8	+4.0	+60.3	+65.3
Indonesia (JSX)	2,108.8	+4.9	+55.6	+69.2
Malaysia (KLSE)	1,083.0	+2.6	+23.5	+22.3
Pakistan (KSE)	7,047.3	+0.8	+20.2	+17.4
Singapore (STI)	2,391.2	+0.3	+35.7	+34.5
South Korea (KOSPI)	1,414.9	nil	+25.8	+27.1
Taiwan (TWI)	6,462.3	−6.3	+40.8	+41.3
Thailand (SET)	624.6	+7.3	+38.8	+41.6
Argentina (MERV)	1,655.0	+3.4	+53.3	+40.8
Brazil (BVSP)	53,410.0	+2.5	+42.2	+70.5
Chile (IGPA)	15,406.7	+2.5	+36.1	+53.4
Colombia (IGBC)	9,452.4	+1.5	+25.0	+37.8
Mexico (IPC)	25,183.7	+2.2	+12.5	+14.0
Venezuela (IBC)	43,166.4	+0.3	+23.0	+32.4
Egypt (Case 30)	6,210.4	+0.6	+35.1	+32.9
Israel (TA-100)	817.8	+0.8	+45.0	+39.3
Saudi Arabia (Tadawul)	5,941.2	−1.8	+23.7	+23.8
South Africa (JSE AS)	23,286.7	+1.0	+8.3	+24.2
Europe (FTSEurofirst 300)	880.0	+1.4	+5.8	+6.6
World, dev'd (MSCI)	987.5	+0.5	+7.3	+7.3
Emerging markets (MSCI)	789.1	+0.6	+39.2	+39.2
World, all (MSCI)	251.2	+0.5	+10.3	+10.3
World bonds (Citigroup)	781.3	−2.0	−3.5	−3.5
EMBI+ (JPMorgan)	437.9	−0.1	+11.9	+11.9
Hedge funds (HFRX)§	1,074.5	−0.5	+5.3	+5.3
Volatility, US (VIX)	28.5	31.0	40.0	(levels)
CDSs, Eur (iTRAXX)‡	118.4	−2.9	−41.4	−41.0
CDSs, N Am (CDX)‡	174.1	−3.2	−25.4	−25.4
Carbon trading (EU ETS) €	13.3	−7.1	−17.6	−16.9

*Total return index. †New series. ‡Credit-default swap spreads, basis points. Sources: National statistics offices, central banks and stock exchanges; Thomson Datastream; Reuters; WM/Reuters; JPMorgan Chase; Bank Leumi le-Israel; CBOE; CMIE; Danske Bank; EEX; HKMA; Markit; Standard Bank Group; UBS; Westpac. §Jun 9th

Stockmarkets

Jun 11th 2009
From The Economist print edition



It has not been a good year for shares. The MSCI World index, which incorporates equity prices from all the world's big companies and exchanges, fell by 34% in the year to June 9th. Markets in rich countries saw bigger declines than those in the emerging world, where some markets even rose, with Venezuela's surging by 18%. India's market, buoyed by cheer about election results and relatively robust first-quarter GDP figures, was slightly higher than a year earlier. Elsewhere, the declines have been indiscriminate. Bourses with stocks specialising in mining (Australia), pharmaceuticals (Switzerland), or carmaking (Japan) have all deteriorated by more than 25%.